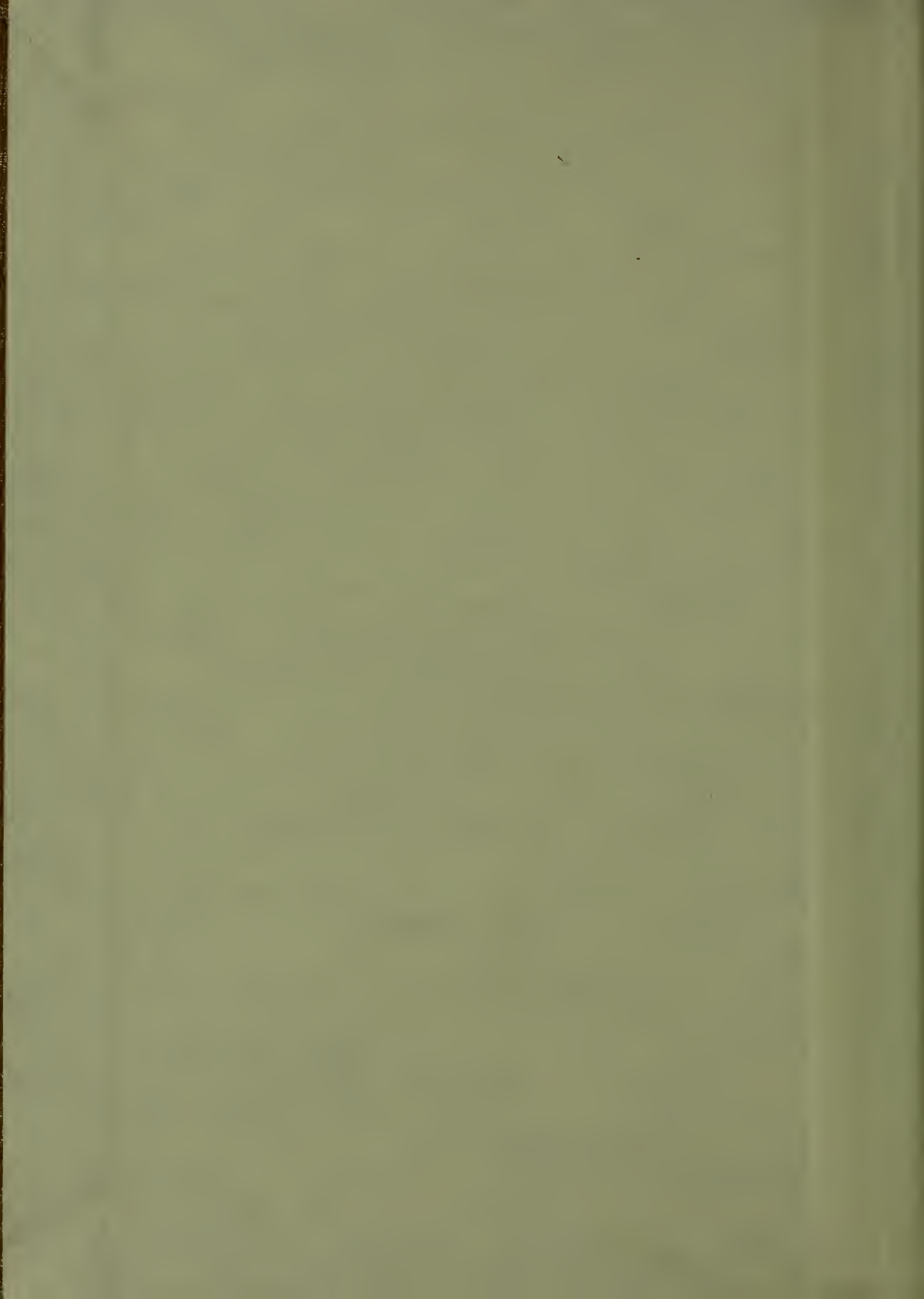
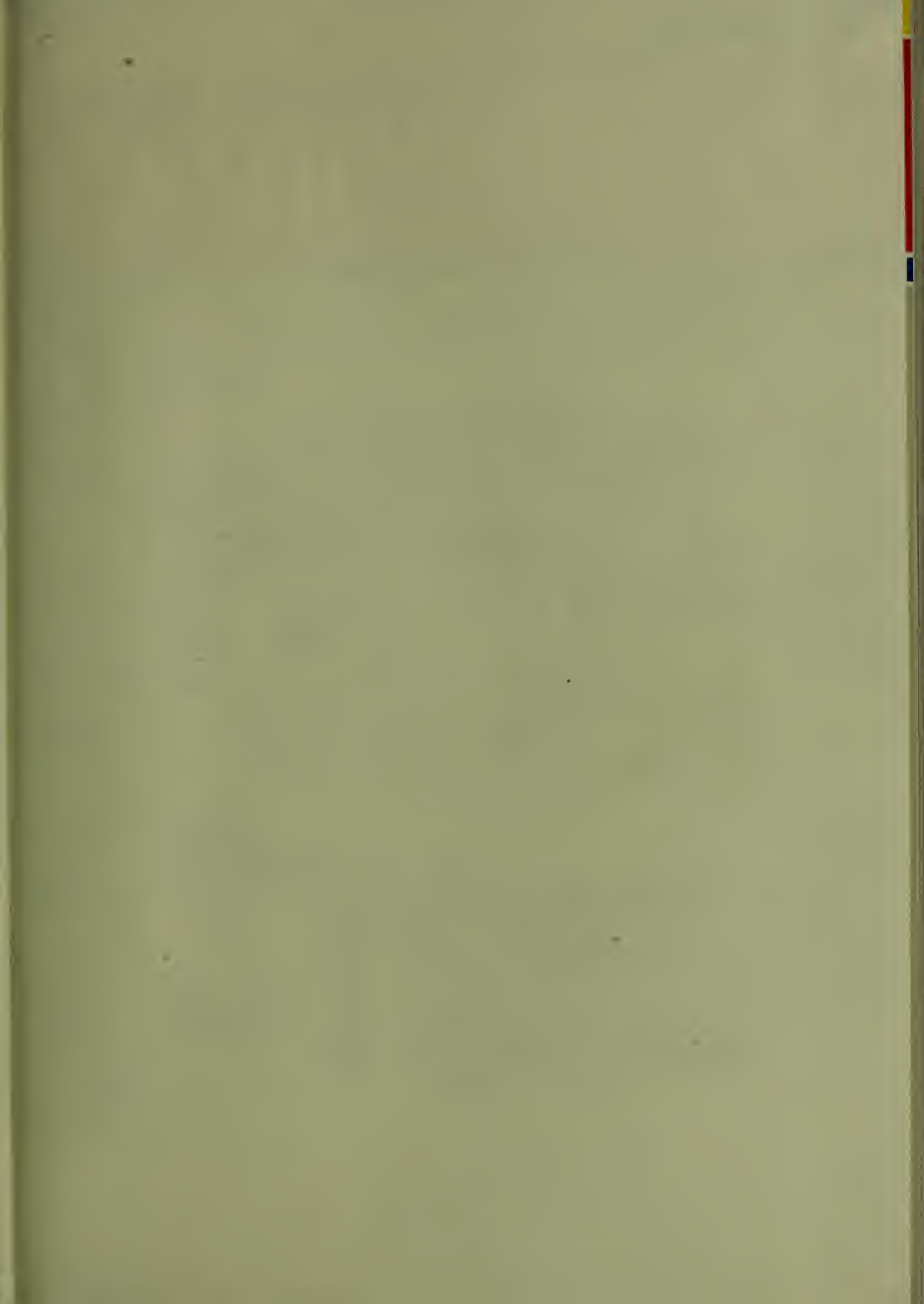




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D'S
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TING OUT
MARTHA

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VISM

MIDYEAR INVESTMENT GUIDE

PICKING

With the indexes
down, stock selection is the key
to making money

STOCKS

Where to look in

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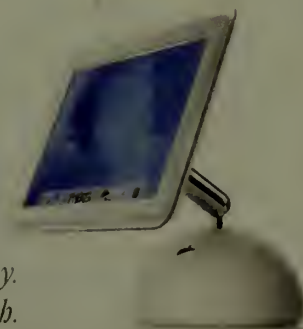
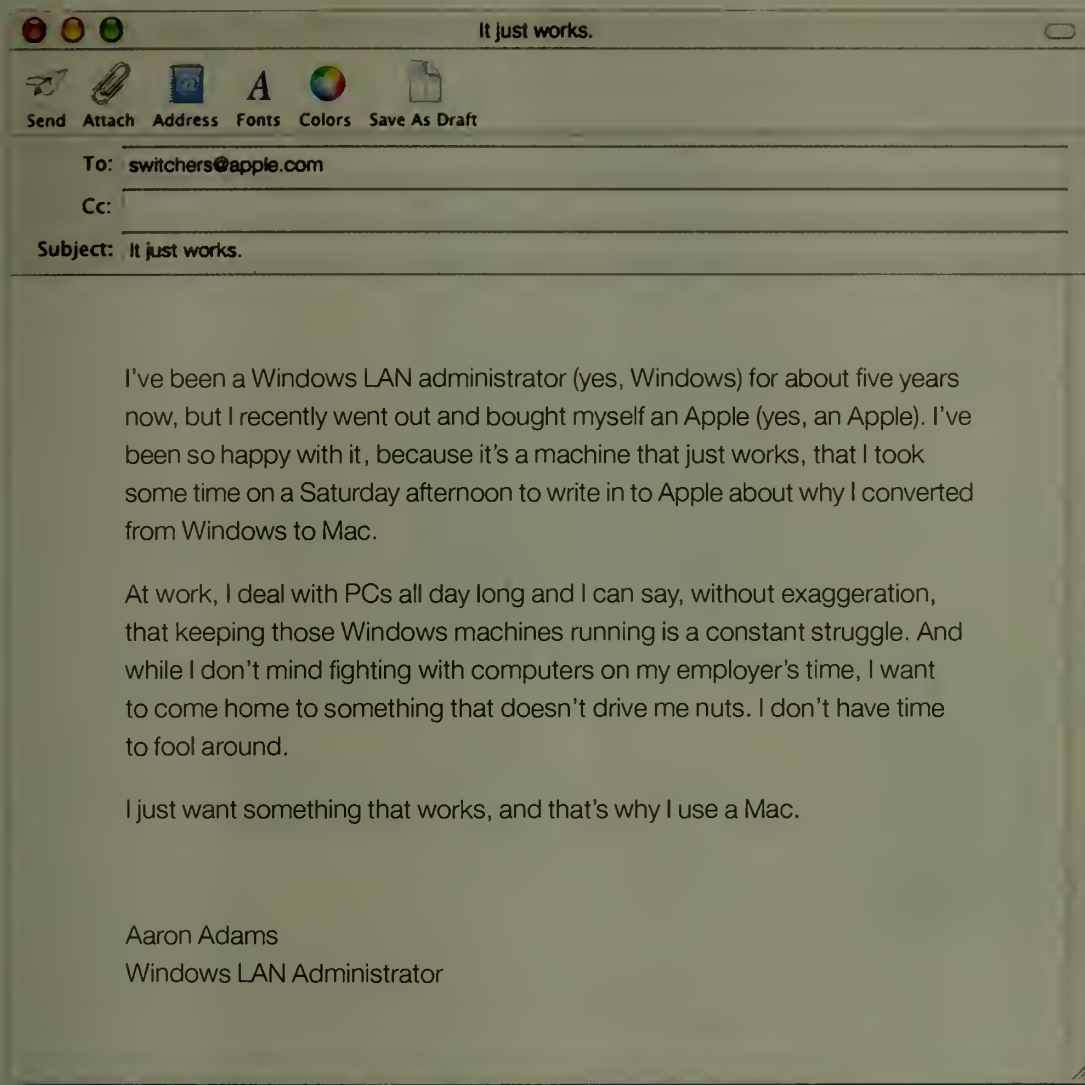
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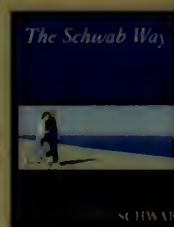
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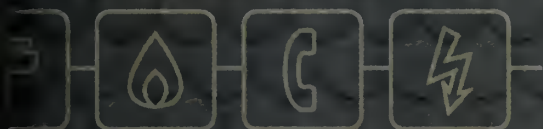
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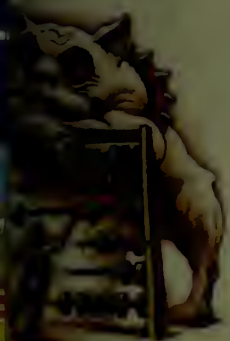
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One client at a time.

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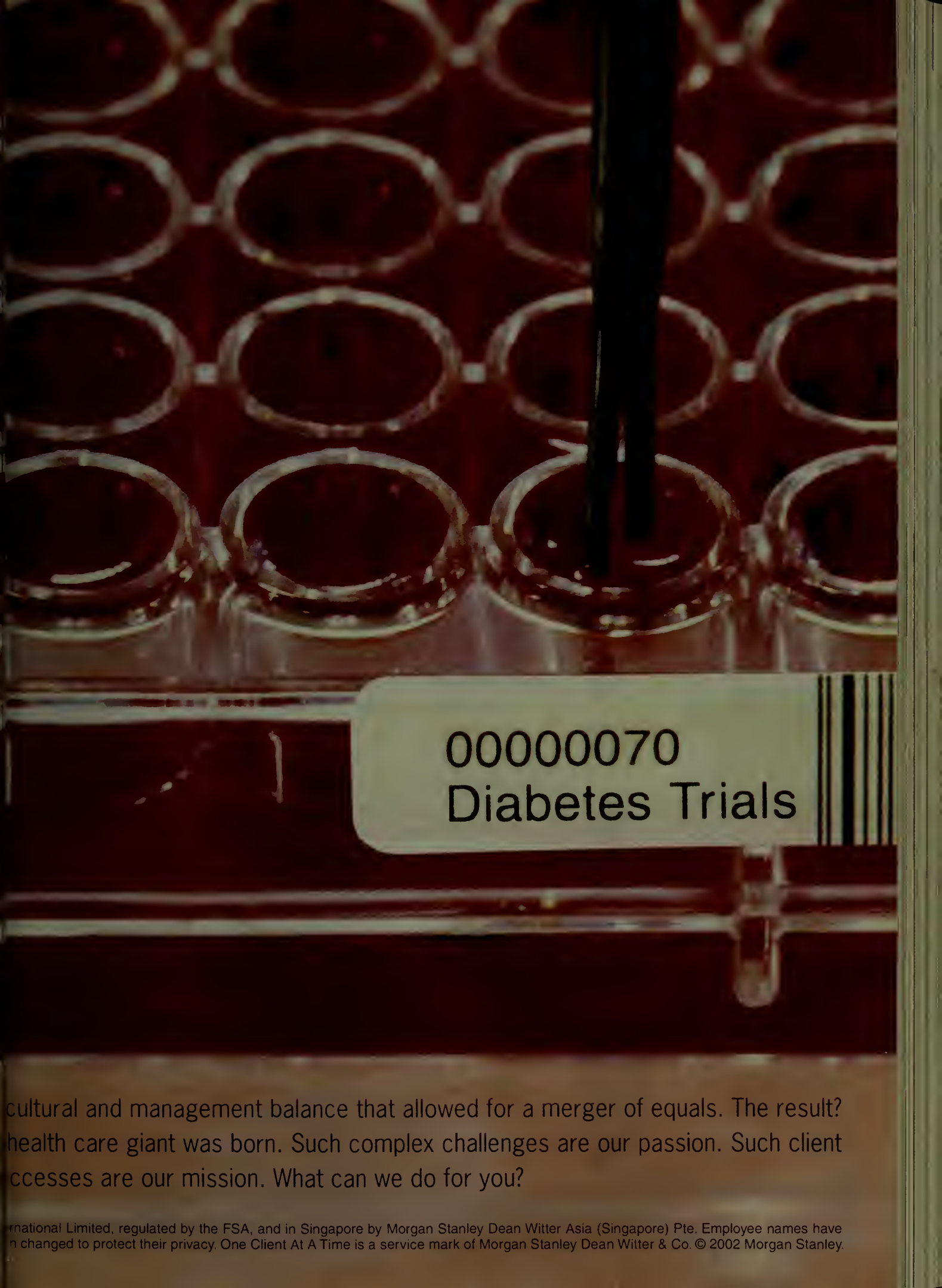
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TOOLS

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Use more than 70 criteria to pan for gold among the equities



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Chief Ethical Officer

If only that's what CEO stood for these days. Instead, greed, hypercompetitiveness, and more have pushed too many top execs to cross the line without fear of consequences



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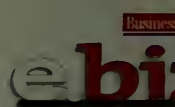
Smart Answers: Deciding to buy a franchise depends on personality as well as economics



TECHNOLOGY State-of-the-art coverage of info tech

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Clicks & Misses: TheKnot and WeddingChannel are two wedding-planning sites. One takes the cake



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Up Front

Qwest

Annual Shareowners Meeting

DODGES

MEET YA IN PODUNK, SHAREHOLDER

ANNUAL MEETINGS, THOSE typically innocuous corporate events, are kicking up plenty of controversy these days. Corporate-governance experts point to a growing trend among companies—particularly those with angry shareholders—of holding annual meetings in suspiciously out-of-the-way venues.

Companies claim that picking far-flung places makes meetings accessible to people in other parts of the country. Critics see another motive. “They do this to avoid shareholders” and protesters, says Nell Minow, co-founder of governance site The Corporate Library.

For example, Qwest Communications, based in Denver (page 46), moved this year’s heavily policed meeting to 20 miles outside of Columbus,

EDITED BY SHERIDAN PRASSO

Ohio, where 2,000 employees work (compared with 15,000 at headquarters). Ohio isn’t among the 14 states where Qwest offers service. A spokesman maintains that the locale aimed “to give Qwest shareowners outside of Colorado an opportunity to participate.” Actually, plenty of angry ones showed up.

Another company that moved its meeting far away, to London, was Morgan Stan-

TALK SHOW “There are a lot of people who don’t know anything about soccer, like me, but we know we are excited and pulling for you.”—President Bush, to the U.S. soccer team before its match with Mexico. He declined an invitation to watch Mexican President Vicente Fox at 2:30 a.m., citing a need to sleep.

ley, which expected demonstrations against its financing of a dam in China. A spokeswoman says that “50% of our business comes from overseas” and that the company wanted to reach out. Activists went to London, too.

Governance experts have a message for controversy-dodging execs: “You can run,” says Minow, “but you can’t hide.” *Kimberly Weisul, with Christopher Palmeri*

THE LIST TAKING IT ON THE ROAD

Companies say moving annual meetings away from headquarters makes it easier for far-flung shareholders to attend. But critics claim execs are trying to dodge unfriendly crowds. A sample:

COMPANY/HEADQUARTERS	2002 ANNUAL MEETING	EXPLANATION
DISNEY Burbank, Calif.	Hartford	It’s near ESPN, which Disney owns. Disney began moving venues after a tumultuous 1997 meeting.
GENERAL MOTORS Detroit	Wilmington, Del.	GM started shifting in 1991 after grueling annual meetings; settled on its state of incorporation in 1995.
HOUSEHOLD INTERNATIONAL Prospect Heights, Ill.	London, Ky.	Company has a call center there; Household’s 2001 meeting was at its offices in Brandon, Fla.*
MORGAN STANLEY New York	London	Morgan says it wants to give more access to overseas investors; 2001 meeting was in the New York area.
NORTEL NETWORKS Brampton, Ont.	Halifax, Nova Scotia	It began rotating among Canadian cities after criticism of its commitment to Canada, among other things.
QWEST COMMUNICATIONS Denver	Dublin, Ohio	Qwest says it wanted to be near shareholders and employees in the Midwest.

*Anti-“predatory lending” demonstrators attended both Data: BusinessWeek

BRAND ‘EM

CAMPARI AND CD?

IT’S NOT ENOUGH TO BE A hangout for jet-setting celebs. Today’s hip restaurants, bars, and hotels are going further—breaking into the music business with their own CDs. The Standard Hotel in Los Angeles, Sunset Beach hotel/restaurant in New York’s Hamptons, and the Buddha Bar and Man Ray in Paris are just a few cashing in on the “lifestyle music” trend.

Retailers such as Starbucks, Old Navy, and Pottery Barn have been selling their own compilations at the checkout line for years. But hip restaurateurs and hoteliers have gone an extra step, selling CDs nationwide in stores such as Tower Records and Virgin Megastore.

Since its release in April, *Buddha Bar IV* (\$29.98), a double CD compilation of remixed world music, has been selling 2,200 copies a week,

putting it on the Billboard Top 20 Dance Chart. Says John Pace, vice-president of George V Records, the label behind it: “This is a whole new way of doing music business.” The Standard’s *Room Service* (\$16.99) has sold more than 30,000 copies since its 2001 release. Explains its producer, Alex Calderwood: “With the explosion of music options, people look for a point of view.” The new “hip CD” biz delivers it. *Julia Cosgrove*



GOTTA BE HIP

SPRINT’S SPRIGLY MARKETING PUSH

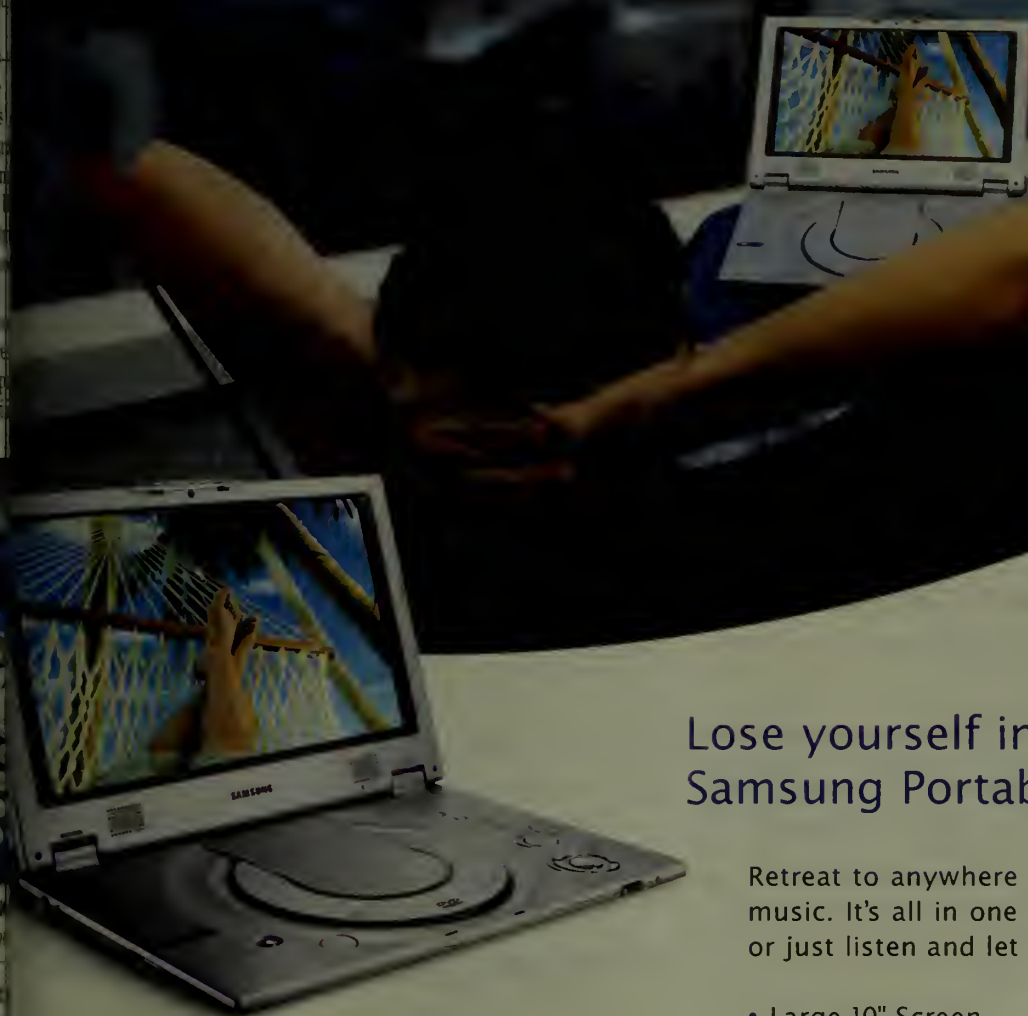
THE VIRGIN MEGASTORE Chicago’s Magnificent bristles with energy. Videos flash, and bass R&B thumps. For the and twentysomethings this store is far cooler than the drab, beige Sprint wireless store a few away. That store is for ents. So Sprint plans to better job reaching out to crucial under-25 through a joint venture with Virgin. Sprint will offer the network, and Virgin provide irreverent marketing and pay-as-you-go plans that appeal to the young. Samsung and others will make phones loaded with music and games. Launch of the Virgin-branded service is imminent.

BusinessWeek has learned there are more such ventures on all teen the way. Nextel is currently negotiating similar “teen” service with different partner. And Mart Stores is exploring own branded service at lower-income shoppers according to a telecom executive close to the company. With annual subscription growth now just 14%—of what it was in 2000—and lower-income folks key to wireless’ growth, egypt. Teens alone are expected to spend \$10 billion on phone service this year, a 26% increase. Says Adv consultant Andrew “Those are hypergrowth markets.” *Roger O. Cro*

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Up Front

9 TO 5

BORED TO DEATH AT WORK—LITERALLY

NODDING OFF AT WORK MAY be as hazardous to your health as it is to your job security. People who struggle to stay alert in boring, passive jobs are 33% to 35% more likely to die prematurely than those who have more active jobs, a new study finds. Work that is highly demanding but offers little decision-making opportunity—on an assembly line, for instance—makes an untimely demise 43% to 50% more likely.

The reason? Tedious work can trigger stress-related hormones in the

brain, and a boring workday often leads to hazardous habits like drinking and smoking. Bored workers are also less likely to exercise, says Benjamin Amick III, a behavioral sciences professor at the University of Texas who examined data from 5,000 families from 1968 to 1992. "It's an urgent problem," he says.

To address it, managers should tell employees why their jobs are important, redistribute tasks to keep them engaged, and hold meetings to hear concerns, says Amick. "More satisfaction leads to improved physical and mental health and saves money through reduced health-care costs and improved productive time at work." Coffee, anyone? *Andrew Heller*



HAVES AND HAVE-NOTS

WANT 3G? MOVE TO THE STICKS

THE NEXT BIG THING IN wireless Internet connection—3G—promises streaming video and other cool broadband features. It's available in Europe and Japan. But if you want it in the

But companies find it more economical to set up wireless networks than to string cable over long distances. The small operators setting up wireless networks don't carry the heavy debt loads of big companies, so are able to move more quickly. It also helps that Senator Conrad Burns (R-Mont.), who co-chairs the Congressional Internet Caucus, is a champion of universal Internet access, particularly in underserved rural markets. A Commerce Dept. study in 2000 estimated that fewer than 5% of towns with populations of 10,000 or less had DSL or cable modem service. "We've got a lot of dirt between light bulbs here," says Burns.

The trio of wireless companies offering 3G in Montana began service in early June. Similar networks are planned for Hawaii and around Vancouver. Take that, Silicon Valley. *Amy Cortese*



MONTANA: Wireless frontier

U.S., you'll have to move to Missoula, Mont., or one of the other rural areas now getting the latest technology first.

It may seem ironic given that the high-tech meccas in the U.S. are far, far away.

DRAWN & QUARTERED



AFTERLIVES

FROM AXMAN TO MISSIONARY

AS CEO OF THE TIMES MIRROR newspaper group, Mark Willes cut costs with near-religious fervor, closing the *Baltimore Evening Sun* and *Newsday's* New York City edition and eliminating 3,000 jobs.

Today, rather than deadlines and debt structure, the 60-year-old onetime Wharton finance professor is devoted to the Mormon church. Long an active church member, he now runs its Honolulu Mission, guiding 200 18- to 21-year-old convert-seekers.

Willes received a \$9.2 million severance in 2000 when the Tribune Co. merged with Times Mirror and now gets

\$970,000 a year in retirement benefits. He had intended to teach media management at Brigham Young University and moved home to



WILLES: Utah must wait

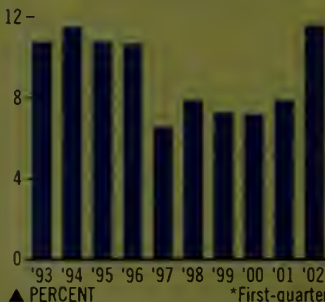
with his wife, Laura. But his uncle, Mormon Church President Gordon B. Hinckley, asked Willes to run the mission for three years. Willes now tours the Hawaiian islands giving talks. God "has given us a perfect plan for living," he told a motivational meeting at BYU's Honolulu campus just after September 11.

Reached at the Mission, Willes declines to say about his new life: "I'm just being here just doing this fulfilling work." *Ron C.*

THE BIG PICTURE

STARTING UP IN A DOWNTURN

Think more fired people started businesses in the tech boom? Act up: the percentage of laid-off managers and execs doing startups dropped then, but has now returned to the levels of the early 1990s.



QUARTERLY SURVEY OF 3,000 DISCHARGED MANAGERS AND EXECUTIVES
Data: Challenger, Gray & Christmas

Polls, surveys, and other items for consideration in this section should be sent to upfront@businessweek.com

This is about the investor who uncovered
an extra \$19,751

by simply doing
a little digging.



While investing can never promise a sure thing, it does offer a few absolutes. One being that, if you have two funds and both perform identically, the fund with the lowest expense

ratio will ultimately return more than the other.

Which is why it pays to scrutinize a fund's fees and expenses up front.

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TAX-LAW CHANGES AND THE BALLOONING U.S. DEFICIT

In "Wanted: A bold budget debate" (Editorials, June 10), you judged the Democrats to be in the wrong for blaming President George W. Bush's tax cuts for the deterioration in the U.S. fiscal situation. Facts suggest that they are not exactly guilty as you charge.

In testimony to the Senate Budget Committee on Jan. 23, 2002, the director of the Congressional Budget Office presented a table that attributes 60% of the deterioration in the projected surplus for the period 2002-11 to legislative changes. Specifically, 30% is attributable to tax-law changes.

In 2002, only about 10% of the shift from a surplus of \$313 billion to a deficit of \$21 billion was attributed to tax-law changes. However, that was in January when the deficit was projected to be about only \$21 billion for the year. With estimates of the deficit for the fiscal year ending September, 2002, now ranging from \$100 billion to \$150 billion, it remains to be seen how big the role of the tax cuts was.

V. Anantha-Nageswaran
 Credit Suisse
 Singapore

CAN KOREA KEEP ITS COOL STATUS?

"Cool Korea" (International Business, June 10) fascinated me because I got to see the names of two of my favorite Korean pop acts in print in an American magazine. You say: "Sixteen-year-old teen pop diva BoA's first album, *Don't Start Now*, has dominated the charts in Japan this year." But *Don't Start Now* was BoA's "1.5 Special" album (the release between her first and second). It did not dominate the Oricon charts in Japan. It was not until her fourth single, *Listen to*

My Heart, reached No. 1 on the Weekly Chart that she truly established herself in the J-pop market. Because of this success and her growing popularity, BoA released a full-length Japanese album and re-released her Korean album in Japan. Her sixth single is the Japanese version of the song *Don't Start Now*.

You also say: "H.O.T., a boy band that blends hip-hop, R&B, and dance music, is big in China." H.O.T. was the biggest Korean pop group and very well-received in China, promoted by SM Entertainment as well as other Korean record companies to introduce more Korean pop culture to China and Taiwan. But H.O.T. has been disbanded for nearly a year.

Stina
 A

Editor's note: Writer Chyn is correct on both points.

Having spent two separate years in Korea, 1996 and 2000, I was impressed with Korea's economic boom. However, you should have stated that the military personnel stationed in Korea since the 1950s have stabilized and protected that country. Without the U.S. military, Korea might not have had the chance to "blossom" into the high-tech cool status it has today.

Craig Carper
 Calcium,

FOREIGN WORKERS DESERVE A LIVING WAGE

"The threat of protectionism" (Editorials, June 3) says that "unqualified imports of free trade makes for sound economics as well as sound economics." Sound international trade not have some element of justice? "Unqualified" free trade forces U.S. businesses and workers to compete with foreign workers who

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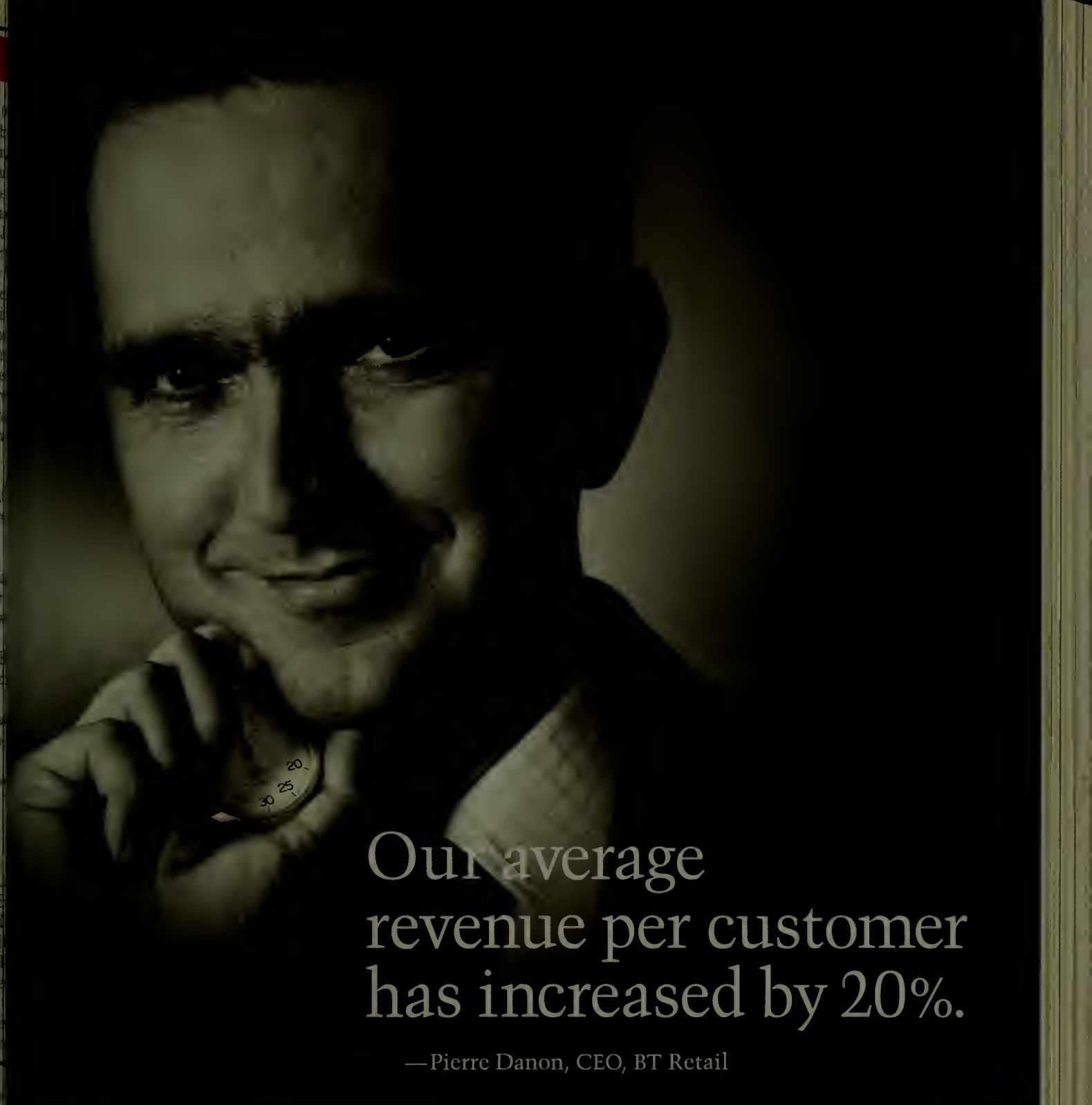
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Readers Report

CORRECTIONS & CLARIFICATIONS

In "Restoring Trust in Corporate America" (Cover Story, June 24), we incorrectly reported that Fannie Mae CEO Franklin D. Raines urged his colleagues in the Business Roundtable to oppose the New York Stock Exchange's proposal to put all stock-option plans to shareholder votes. It was General Mills Inc. Chairman Stephen W. Sanger who did so.

We also incorrectly reported that Microsoft Corp. was required to restate its financial results. Microsoft reached a settlement with the SEC earlier this month into the company's accounting reserve practices during fiscal years 1995-98, but is not required to restate its financials. Microsoft did not admit or deny any wrongdoing in the settlement.

"Merrill: Is Stan the man?" (Finance, June 17) incorrectly said that Salomon Smith Barney brokers manage more assets per head than those at Merrill Lynch & Co. in the U.S. In the first quarter, Merrill brokers averaged \$84 million each, vs. \$78 million at SSB. Also, Merrill now calls its brokers "financial advisers."

"Covering your behind at Tyco" (Up Front, June 24) should have clarified that although Tyco International Ltd. General Counsel Mark Belnick's employment contract entitles him to a termination payment of up to \$10.6 million for being terminated with cause, he is entitled to only one-third of that amount if terminated before October 1, 2002.

making less than enough to provide a minimally decent standard of living. Is it just that those of us who are fortunate enough to have a decent standard of living enjoy low prices because someone who made the product gets \$2 per day?

Would it not be just for the U.S. to say that we will not accept imports unless the workers are paid a minimum of, say, \$6 per hour? Such a policy would raise living standards and permit all workers to have at least some human dignity, to which we are all entitled.

Gregory Hurley
West Point, Ga.

HDTV IS HERE TODAY (SORT OF)

While most of your observations were on track, "HDTV: High-anxiety television" (BusinessWeek Lifestyle, June 10) contained two facts that are incorrect.

You refer to the 720p high-definition format as a small-cinema format that is better than 480p but not as good as

1080i. In 1998, TV industry experts on the Advanced Television Systems Committee determined that 720 lines progressively scanned produced equal or better HD pictures than 1080i, which is why 720p was included in the HDTV standard. Without getting involved in technical minutiae, suffice it to say that progressively scanned images produce sharper pictures—if this were not the case, computer displays would be interlaced. On both large and small displays, 720p produces sharper pictures.

Also, the ABC television network sends out more than "a few" of its prime-time shows in 720p HDTV. Beginning last September, ABC began broadcasting all of our scripted prime-time programming—including all of our dramas and comedies and the majority of our Saturday and Sunday movies.

Also, ABC is the only major broadcast TV network that lives up to the "full" DTV standard by regularly providing 5.1-channel surround sound during all of its HD broadcasts.

Preston Davis
President

Broadcast Operations & Engineering
ABC Inc.
New York

If you buy an HDTV or "HD-ready" set today, it will not be obsolete next year. It will give you spectacular performance from DVD. If you add an HD satellite receiver from DirecTV or DISH Network, you will be able to get Showtime and HBO in high definition. On DirecTV, you'll also get 24-hour, mostly sports HDnet in HD. On DISH, you'll get CBS in HD. These boxes will also get network terrestrial HD feeds. Next fall, all of CBS' evening programming will be in HD. NBC will deliver 11 prime-time hours weekly, and ABC will do likewise, meaning HDTV is happening much faster than color did a few decades ago.

Millions of Americans will find that they can buy a set, have a dish and antenna installed, and watch 100 or more hours of HDTV programming every week.

Michael Fremer
Wyckoff, N.J.

Editor's note: The writer is a contributing editor to Stereophile Guide to Home Theater.

I'm ready to spend big dollars to get that perfect HDTV system. However, I always remained confused whenever I spoke with "experts" as to the best course of action. Now I have the information I need: wait.

Ken Fries
Muskego, Wis.

SHE'S LOYAL TO LOUIS RUKEYSER

Although I did not speak with reporter, my name was mentioned. "You're either for Lou—or against" (Up Front, May 27). The article indicated that Louis Rukeyser has pressure elists not to appear on his former program, *Wall Street Week*. To set the record straight, I declined to appear on the program out of loyalty because I was appalled that Maryland Broadcasting had replaced, then fired, Louis Rukeyser. I declined before I had even met him, and well before he had lined up another program. At no time has Rukeyser or anyone associated with him suggested that I or, to my knowledge, any of the other panelists, should not appear on the old program.

Mary C. F.
Investment Strategist
UBS PaineWebber
New York

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BEACH READS THAT AREN'T LIGHTWEIGHTS

Epistemology, anyone? Last summer, I surprised my wife by carrying to the beach a 550-page cover book on the American school pragmatist philosophers. Then I got hooked by reading aloud engrossing passages—for example, on how writing analysis based on probability theory figured in a celebrated mid-century lawsuit over a whale-oil mine.

Now, you can have the same beach-tet fun with less of an arm-weary-workout. City University of New York literature professor Louis Menand's *The Metaphysical Club: A Study in Ideas in America*, which won the Pulitzer Prize for history, is just in paperback (Farrar, Straus & Giroux, \$15). There's plenty of philosophy here: Kant, Hegel, and Locke all do, as, of course, do the men at the heart of the story, American intellectuals Charles Sanders Peirce, William James, and Thomas Dewey. But Menand enriches his book with other fascinating details, including an account of how the Civil War cleaved an intellectual gulf between the moralistic, abolitionist generation of Oliver Wendell Holmes Sr. and the combat-bludgeoned, skeptical generation of Oliver Wendell Holmes Jr.

Still too heavy? Well, it's only one of the widely varying books in *BusinessWeek's* annual summertime roundup of new paperbacks.

Another set of gripping historical portraits can be found in Joseph J. Ellis' *Founding Brothers: The Revolutionary Generation* (Vintage, \$14). Nothing was certain in the chaotic decades after the U.S. Declaration of Independence. America could have easily splintered into regional republics or fallen to the British military. The country, says the Mount Holyoke College historian, was "an improvisational affair, in which sheer chance, pure luck...and specific decisions" determined both the U.S.'s survival and its political institutions. Key were the efforts of Ellis' cast of combative revolutionaries: John and Abigail Adams, Aaron Burr, Benjamin Franklin, Alexander Hamilton, Thomas Jefferson, James Madison, and George Washington. "What emerges are bustling stories that achieve Ellis' goal of describing how our early republic 'looked and felt,'" found reviewer Dennis K. Berman.

If more recent politics interests you, there's *Before the Storm: Barry Goldwater and the Unmaking of the American Consensus* (Hill & Wang, \$17). Author

Rick Perlstein, who has written for *The New York Times* and *The Nation*, suggests that the enduring political legacy of the 1960s came not from the much-publicized New Left but from the rightist movement that formed around the 1964 Republican Presidential candidate. In this account, Goldwater comes across as rude, crude, surly, and moody. But the focus of Perlstein's work is on the intellectual heavies, canny political operatives, and far-out conservative fellow travelers—including the likes of William F. Buckley Jr., Warren Burger, Robert Bork, Caspar Weinberger, and William Rehnquist. Reviewer Richard S. Dunham found the analysis of their ultimate rise to power "comprehensive and compelling."

Two business titles take stock of the federal antitrust litigation against Microsoft Corp. *World War 3.0: Microsoft vs. the U.S. Government, and the Battle to Rule the Digital Age* by *The New Yorker* writer Ken Auletta (Broadway, \$16.95) places the reader inside the courtroom. The action commences with the opening arguments of Oct. 19, 1998, before federal judge Thomas Penfield Jackson, and the narrative takes readers up to the November, 2001, accord between the U.S. government and the

PAPERBACKS FOR FANS OF HISTORY, PHILOSOPHY, ART, POLITICS, AND CORPORATE INTRIGUE

corporation. Auletta offers arresting portraits of such key figures as prosecuting attorney David Boies and Microsoft Chairman William H. Gates III. He observes that the latter "wouldn't be picked out of a lineup as a leader of men." But the author's coup came in getting the judge to express his personal opinions about the parties—for instance, calling Gates "Napoleonic" and "arrogant."

Wired magazine correspondent John Heilemann's **Pride Before the Fall: The Trials of Bill Gates and the End of the Microsoft Era** (Perennial, \$14.95) isn't about the trial per se but about everything that went into the litigation. Heilemann shows how the anti-Microsoft movement evolved from the complaints of a few Silicon Valley executives into a federal case. He details the troubles the Justice Dept. had in getting Microsoft's detractors to testify on the record. And he ushers the reader into many of the bargaining sessions between Justice and the corporation's lawyers. This book, which has a new epilogue discussing the appeals

court ruling and the Bush Justice Dept.'s settlement, is "almost like a thriller—fast-paced and hard to put down," found reviewer Dan Carney.

Dennis McDougal's **Privileged Son: Otis Chandler and the Rise and Fall of the L.A. Times Dynasty** (Da Capo Press, \$18) tells two related stories: The emergence of *The Los Angeles Times* as the most powerful newspaper in the West and the history of the Chandler family that dominated that paper, and Southern California, for much of the 20th century. "The author's depiction of some of the major players is compelling, especially that of Harry Chandler," the paper's longtime publisher and the head of a vast business empire, said reviewer Chris Welles. The figure who dominates the book, though, is Otis Chandler, Harry's grandson. McDougal, a former *Los Angeles Times* writer, describes the transformation of the scandal sheet into a respected newspaper—and the paper's ultimate decline and takeover by Chicago-based Tribune Co.

For what reviewer Patricia Kranz found to be a "vivid and entertaining"

glimpse of Russia during the boom years of 1996 to 1998, check out Matthew Brzezinski's **Casino Moscow: A Tale of Greed and Adventure on Capitalism's Wildest Frontier** (Touchstone, \$14). To describe a time when oligarchs lived like czars and Western investment bankers sold stocks all day and drank in strip bars all night, the former *Wall Street Journal* staff writer casts himself, his friends, and his relations among the main characters. For example, when his wife takes a high-paying job with a private investment group, Brzezinski tells how he becomes infected with the spirit of the times—and dreams of buying a yacht. But the author also keeps one eye on the have-nots—the millions of Russians who have to sell heirlooms or their bodies to survive.

Those who are drawn to exotic places may enjoy **River Town: Two Years on the Yangtze** by *New Yorker* contributor Peter Hessler (Perennial, \$13.95), a book

that reviewer Karin Pekarchik found "perceptive and engrossing." As a Peace Corps volunteer, the author traveled in 1996 to the remote Sichuan city of Fuling, the first outsider there in half a century.

Sent to teach literature and writing at the local teachers' college, he quickly became a student himself. He was exposed to haunting stories of persecution and starvation during the Mao Zedong period. And he struggled to understand local "passivity" in the face of daunting change—including the construction of the huge Three Gorges Dam, which is set to begin flooding the area in 2003, transforming an area where millions now live.

Ryszard Kapuscinski's **The Shadow of the Sun** (Vintage, \$14) is a distillation of 40-odd years of visits to Africa by a distinguished Polish journalist. The author's method is to skip the strongmen and corruption that make headlines and immerse himself in daily life—in the continent of village pathways, roadside tailors, millet beer, and huts shared with cobras. Whether describing his experience of a coup d'état in Nigeria, the difficulties of coping with the constant turmoil and robberies in his Lagos neighborhood, or a brush with death in the Sahara, the author is never less than profound. Said reviewer Patrick

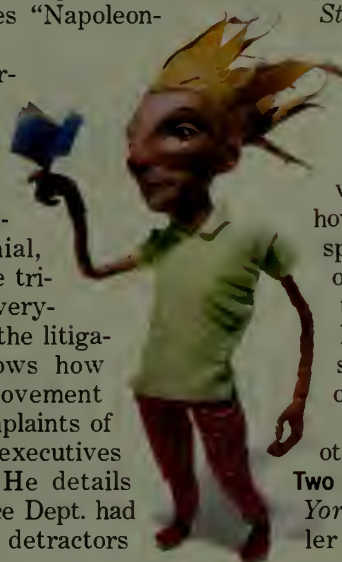
Smith, Kapuscinski explores "that of high, thinly populated ground where journalism and literature occasionally joined."

India's religious conflicts may be the limelight, but on the economic there are some encouraging signs. Gurcharan Das in **India Unbound** (Anchor Books, \$15). For years, an obsession with achieving social equality and self-sufficiency held the country back, says the retired Procter & Gamble executive and columnist for *The New York Times*. This is changing, as India "begun to flex its muscles in the information economy." The origins suffered a bit from pre-tech-bubble hype, but that's tempered by the afterword. Reviewer Pete Enns found the effort to be "one of the most readable and insightful books to date on India's tortuous economic path."

Art lovers will be intrigued by **Vermeer: A View of Delft** by Anthony Olden (Owl Books, \$16). Even though there are thousands of paintings to view in museums, there are only 35 paintings that are accepted as his extant work, extremely little known about this 17th-century painter. But Bailey, who has written books on Rembrandt and J.M.W. Turner, gets around this problem by focusing on the prosperous and broad-minded city in which Vermeer lived. As he argues, far from being a solitarius, Vermeer was in fact a social genre painter working in the tradition of many others in Holland. Reviewer Harry Maurer also found the book to be "good on the paintings, analyzing how they were made, their ambiguous meanings, and their luminous and tactile qualities."

Finally, if too much reality has you longing for a bit of story, check out **Esquire's Big Book of Fiction**, edited by Adrienne Miller (Corgi Books, \$21.95). Most of the book's short stories, which first ran in *Esquire* magazine, are by established masters. This can be handy: If you're not familiar with the work of, say, the late Ray Carver, but you're curious why he received so much praise, his voyeur "Neighbors" is a good starting point. Expect a lot of red-blooded prose, Robert Stone's chilling "Under the Pitons" or Arthur Miller's sans-Misfits "The Misfits." Dos Passos, Nabokov, Fitzgerald share space with more recent *litterati* including Richard Ford, Louise Erdrich, and Jayne Anne Phillips. Even on a rainy day, you'll spend enjoyable hours.

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Two acrobats from Cirque du Soleil are performing a handstand. They have long, spotted, yellow and white limbs that extend horizontally. Their bodies are painted with blue and white patterns, and they have blue face paint. They are holding each other in a handstand position against a dark background.

length + agility = performance

Photo: Al Seib. Costumes: Dominique Lemieux. © 1999 Cirque du Soleil Inc.

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BY STEPHEN H. WILDSTROM

tech&you@businessweek.com

IBM JUST CLUNKED UP MY FAVORITE LAPTOP



Adding something for everyone to the ThinkPad makes it bulkier and power hungry

In the course of a year, I try out as many as two dozen laptops from just about every major manufacturer, and naturally I try to maintain my neutrality in evaluating them. But when it comes to selecting a machine for day-in, day-out personal use, I have long tended to favor IBM ThinkPads. This isn't because I feel ThinkPads are that much better than other laptops. Rather, it's a matter of taste. I find ThinkPads' distinctive personality—the layout and feel of their keyboards and, especially, the TrackPoint pointing stick—appealing.

Alas, there's not much room left for personality in the increasingly commoditized laptop market. The new ThinkPad T30 (www.thinkpad.com), starting at \$2,199, is an updating of the corporate workhorse T23. But it breaks with IBM tradition by adding a touch pad to the venerable TrackPoint. Future ThinkPad models will also use both types of pointing devices.

Unlike many design changes these days, this decision has nothing to do with a margin-strapped manufacturer's need to shave a few bucks off the bill of materials, since the

dual devices add expense. Instead, IBM executives decided they had to change because competitors, including top rivals Dell and Compaq, were offering dual-mode laptops. Corporate purchasing managers, who have to satisfy a broad constituency, have been issuing bid specifications that require both a touch pad and a pointing stick. At a time when no one can afford to forgo a potential big sale, the demands of these customers had to be met.

From the user's point of view, though, adding the second pointing device shows that something that does many things rarely performs a task as well as something designed for one job. The new ThinkPad has two sets of mouse buttons, one just below the space bar for use with the TrackPoint and one below the touch pad. The upper set is somewhat scrunched, with the scroll button jammed between the left and right mouse buttons rather than below them as in earlier designs. More troublesome, putting these buttons above the touch pad means that it's hard to reach the touch pad or, even more so, the buttons below it without moving your hands from

their home typing position. At least you can easily configure the ThinkPad to have both the touch pad and the stick active or turn off either to avoid accidental mouse movement.

There's another way in which the T30 represents what oddly passes for progress these days. It uses Intel's new 1.6-gigahertz Pentium 4 processor in place of the 1 GHz III-M in the T23. To accommodate the greater heat output of the Pentium 4, engineers made the case a little bigger, adding 0.1 inch in thickness. The weight, at 5.7 pounds, is up about 8 ounces, and the battery life, at 3 hours, is down 30 minutes. The bottom line is that I didn't see any benefit from the faster processor—but I sure noticed the increased bulk and shorter battery life.

The T30 does offer one novel touch. You can replace the CD or DVD drive with a tray that holds either a full numeric keypad or a sync charge cradle for any m-series Palm (photo).



THINKPAD T30:

Although unnecessary, the touch pad lets IBM keep up with rivals

But aside from such bells and whistles, the pressure on laptop makers to conform is overwhelming. If corporate buyers want touch pads and track sticks, that's what they'll get, even at a cost in usability. Same with the latest processors from Intel, whether the extra speed is useful or not. It's a shame, but it's today's reality.

For folks willing, as Apple Computer would say, to think different, there is an interesting alternative. The newly updated PowerBook G4, starting at \$2,499, now offers speeds to 800 MHz on its PowerPC G4 processor. At 1 in. thick and 5.4 lb., it's thinner and lighter than the T30. It offers 5 hours of battery life. Its unique wide 15.2-in. display now offers 1280 x 854 pixels, a 23% improvement in resolution from the original model. It uses a touch pad.

Software and support issues make the PowerBook an unrealistic choice for most business users, especially those bound by corporate standards. But it stands as a rebuke to an industry that is increasingly turning out look-alike, vanilla laptops whose try-to-please-everyone signs tend toward boring mediocrity.

BusinessWeek online

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BY GARY S. BECKER

HAPPY BIRTHDAY, MILTON FRIEDMAN



GIANT:
As he approaches his 90th, it must be satisfying to see how many of his ideas have shaped our economic world

Milton Friedman's professional career has been marked by controversy over his many policy proposals. Yet as he approaches his 90th birthday in July, Friedman is increasingly recognized as the most influential economist in a 20th century that witnessed towering contributions from John Maynard Keynes, Paul A. Samuelson, and others.

Friedman is best known for "monetarism," a view that stability in the growth of the money supply is crucial to controlling inflation and recessions. Although the relation between the money supply and the economy has often been highly variable, no less an authority than Federal Reserve Chairman Alan Greenspan has indicated that Friedman's emphasis on a stable monetary framework was instrumental in guiding central banks in Europe and the U.S. toward low inflation during the past two decades.

Before Friedman, economic conventional wisdom held that inflation reduces unemployment because prices rise faster than labor costs. In the late 1960s, Friedman argued instead that there is no permanent reduction in unemployment from continuing inflation because wages eventually catch up to prices as expectations about inflation become more accurate. His analysis has been validated twice since then—by the high U.S. unemployment during the 1970s despite rapid inflation, and the low unemployment during the '90s even though inflation was negligible.

Some of Friedman's contributions to micro policy have been fully implemented, such as his persuasive advocacy of a voluntary army while serving on the Gates Commission set up to reconsider the draft after the Vietnam War. At a recent White House event to honor Friedman on his approaching birthday, I discussed a few of his policy proposals that have only been partially adopted and continue to generate controversy.

Two decades before Chile introduced its revolutionary private individual account retirement system, Friedman's classic 1962 book *Capitalism and Freedom* criticized the prevailing pay-as-you-go Social Security systems for restricting the ability of individuals to choose how much and in what form to save for retirement, and for mixing a welfare program for elderly poor with a compulsory program that applies to all the elderly. Had his advice been followed 20 years ago, there would be no impending Social Security financing crisis in the U.S. and other developed nations with aging populations.

In the same book, Friedman showed that without any change in the tax base, a flat income

tax rate of 23% could bring in the same revenue as the system of rates that ranged in the 1960s from 20% to an incredible 91%. A few years later, he went further by demonstrating that the flat rate could be reduced to 16% without any diminution in tax revenue if all deductions for mortgage interest, charitable contributions, and the like were eliminated.

All nations have since brought down their top rates from frequently above 90% to 50% or less. So the world has moved about halfway toward his flat-tax system.

In the early 1950s, Friedman revived the idea for allowing foreign exchange rates to be determined by supply and demand for different currencies. Flexible rates had fallen into intellectual disrepute because exchange rates were unstable during the 1930s, and after the World War II Bretton Woods Agreement produced a worldwide system of supposedly fixed exchange rates.

Controversy over flexible exchange rates continues as American political leaders continue to pressure Treasury Secretary Paul H. O'Neill for his refusal to seek a strong dollar. Meanwhile, exporters want him to promote a weak dollar that will make their goods cheaper to other nations. Secretary O'Neill is right in his commitment to let markets decide the international value of the dollar rather than government officials or business leaders with vested interests.

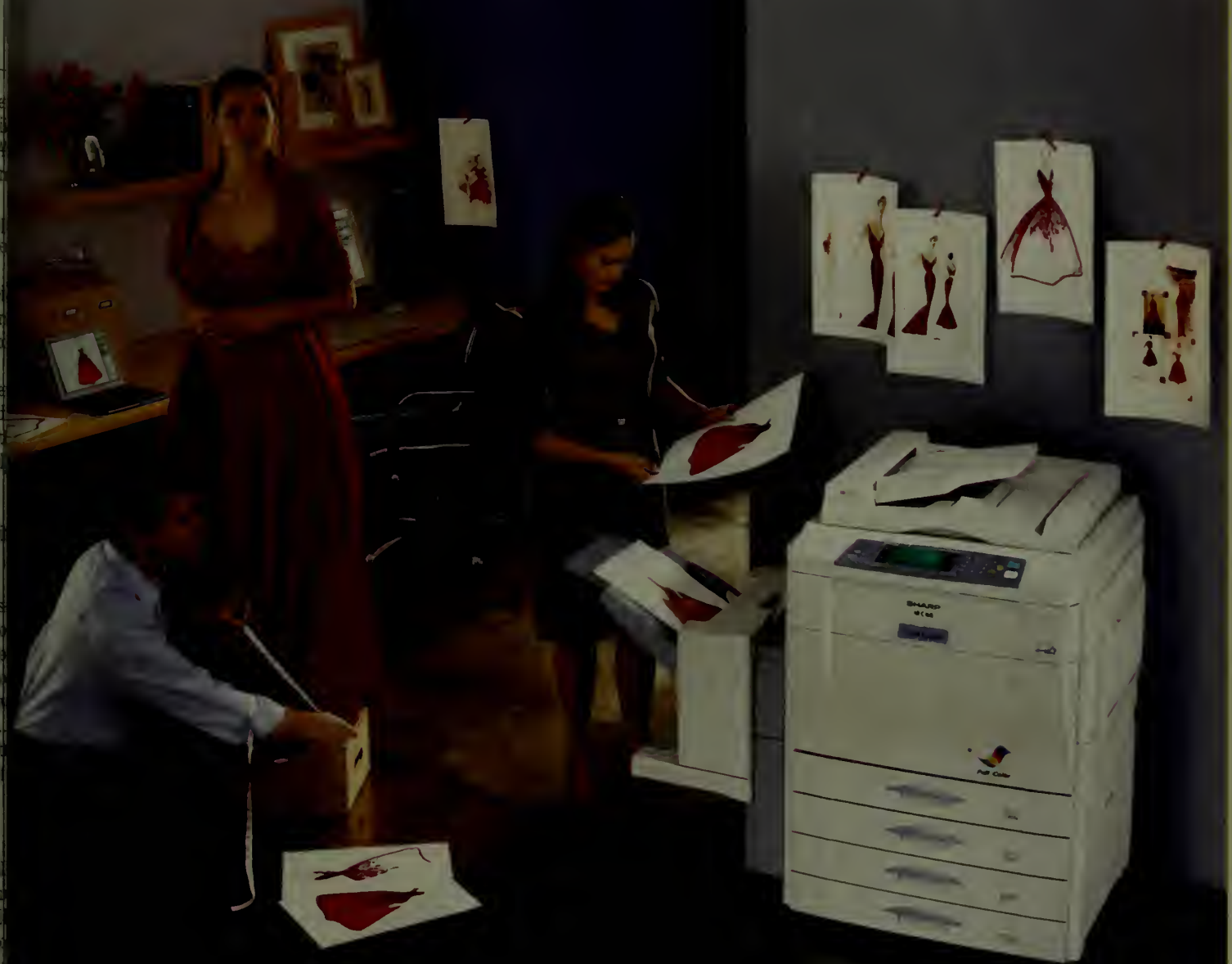
School vouchers is the micro program most closely identified with Friedman. In the 1950s, he first proposed that governments give tax vouchers to parents with school-age children that they could use at private or public schools of their choice as long as these met education standards. He was confident that even poor parents would generally select a good education for their children if they had real choices.

Although voucher advocates have largely won the intellectual battle, vouchers have been effectively opposed by teachers' unions and many suburban parents who fear vouchers will encourage poor children to attend schools in their communities. The U.S. Supreme Court has soon decide the legality of several voucher experiments.

Friedman has displayed enormous courage, sticking to his guns after his work was greeted with hostility and, frequently, nasty personal attacks. It must be gratifying to see how much the world has moved toward his positions. We owe an enormous debt to this great economist as he completes his ninth decade.

Gary S. Becker, the 1992 Nobel laureate, teaches at the University of Chicago and is a Fellow of the Hoover Institution.

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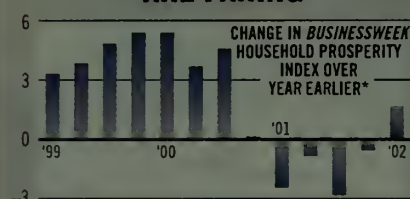
THIS RECESSION WASN'T SO MILD

Wealth declined by over \$4 trillion

There are lots of ways to assess the severity of an economic downturn, including the increase in the unemployment rate or the drop in gross domestic product. By any of these conventional measures, the downturn of 2001 was moderate, at worst.

But a look at household net worth

HOW HOUSEHOLDS ARE FARING



*BASED ON WEIGHTED AVERAGE OF REAL NET WORTH PER HOUSEHOLD AND REAL WAGE AND SALARY INCOME PER WORKER
Data: Federal Reserve, Bureau of Labor Statistics, Bureau of Economic Analysis

gives a completely different picture. The latest figures from the Federal Reserve flow-of-funds accounts, released on June 7, show that total household net worth, adjusted for inflation, fell by 12.3% from its peak in the first quarter of 2000 to its low point at the third quarter of 2001. That represents a total loss of wealth of more than \$4 trillion, or roughly 40% of GDP, with rising debt and a declining stock market only being partly offset by higher housing prices. The only postwar downturn that hit household wealth as hard was the recession of 1973-75.

The decline in household wealth over the past two years pulls down *BusinessWeek's* index of household prosperity (first described in the Apr. 29 issue). This index is based on the idea that households care about both wage income and wealth, especially in an era when so many people own their own homes and have stock investments. The index is calculated using a weighted average of real wage income per worker and real net worth per household.

At its low, in the third quarter of 2001, the index of household prosperity was down by 2.8% vs. the year before (chart). By contrast, the index's worst year-over-year decline in the 1990-91 recession was only 2.1%. During the

1981-82 recession, the prosperity index dropped only by a meek 0.7%. That may help explain why President Ronald Reagan's political support stayed strong during the downturn.

Since the third quarter of 2001, both household net worth and the *Business Week* prosperity index have inched up. Indeed, the prosperity index, through the end of the first quarter of 2002, stands about 1.7% higher than it was the year before, buoyed by a year of rising wages and a strong housing market.

But this gain in the prosperity index may not persist. The stock market has fallen sharply since the first quarter, and real wages seem to have stopped rising. Meanwhile, housing prices across much of the country appear to be leveling out, despite soaring values in a few areas. This combination could well leave many Americans feeling a lot poorer.

GETTING RID OF CORPORATE DEBT

Net stock issuance turns positive

One of the remarkable things about the 1990s was the way most companies relied on debt to fund their operations rather than taking advantage of high stock prices to raise money by issuing equity. Indeed, nonfinancial corporations bought back some \$870 billion in equity from 1995 to 2001. That reflects stock buybacks and equity extinguished as part of mergers. Meanwhile, corporations added debt like crazy, borrowing \$2.1 trillion over the same period. In effect, Corporate America was borrowing to finance its stock repurchases.

But the pendulum may finally be starting to swing back. In the first quarter, despite the drought in initial public offerings, net stock issuance by nonfinancial corporations was actually positive. Meanwhile, net borrowing fell off the cliff, to an average annual rate of less than \$13 billion. That's compared with a rate of more than \$200 billion in the fourth quarter. Companies were still issuing bonds, but they were cutting way back on short-term debt.

This is the first tangible sign of the de-leveraging of the corporate sector. How long might it go on? After the recession of 1990-91, the process of shifting from debt to equity went on for about two years before companies started borrowing at high levels again. It may take even longer to work off the excesses of the last decade.

A NEW LOOK AT EXCHANGE RATES

Floating regimes get a boost

Should countries let their currencies float freely? Economists have debated this for decades. While leading the way, such as Milton Friedman argued for floating rates, the data seemed to show that countries with floating rates had high inflation and sluggish growth.

But economists Carmen M. Reinhart and Kenneth S. Rogoff say those findings can't be trusted because they are based on faulty data from the International Monetary Fund. Reinhart and Rogoff both work for the IMF but most of the analysis before joining the fund. Their study, published by the International Bureau of Economic Research, is an official IMF document.

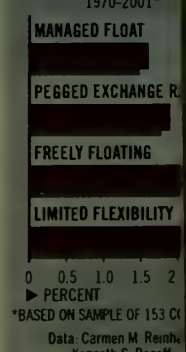
Reinhart and Rogoff say that the IMF routinely misclassified countries with change-rate regimes, especially before 1997, mainly by relying on government data often inaccurate self-classification. Currencies that were described by the IMF as being pegged to another currency or currencies were actually floating and vice versa, the economists say. Reinhart and Rogoff also say that the IMF's classification method was skewed by high inflation in some countries.

So the two devised their own classification system, drawing on more data from 153 countries going back to 1946. They reclassified countries into the four IMF categories and created a new category for countries with high inflation and "freely falling" currencies.

Countries with freely floating currencies look much better under the new classification. Their annual inflation from 1970 to 2001 was 9%, the lowest of any currency regime. Under the old classification, freely floating currencies had 174% inflation, the highest of any regime. Likewise, real GDP per capita for countries with floating currencies grew 2.3% a year from 1970 to 2001 under the Reinhart-Rogoff classification, vs. just 0.5% under the IMF's. The outcome may mean a lot more support for floating rates.

By Peter Coy

FLOATING CURRENCIES HOLD THEIR OWN



*BASED ON SAMPLE OF 153 COUNTRIES
Data: Carmen M. Reinhart, Kenneth S. Rogoff

JAMES C. COOPER & KATHLEEN MADIGAN

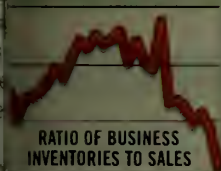
THE ECONOMY IS STABLE— EVEN IF THE MARKET ISN'T

limpy inventories and a stimulative Fed point to continued growth

U.S. ECONOMY Stock investors have been fretting over the unusually high level of uncertainty hanging over this recovery. By June 19, those worries had pulled stock prices down about 7% in only the past month—and more than 12% since March. So now a new question has arisen: Will the stock market drag down the economy?

Probably not. First of all, far more alarming drops in stock prices—think the crash of 1987 or the 2000 collapse in the Nasdaq—have shown that the link between losses in stock wealth and drops in consumer spending is tenuous and that the impact is small. Household wealth has proven to be far more crucial to consumers, and home values are still appreciating.

INVENTORIES LOOK MIGHTY SPARSE



APR. '02
Data: Commerce Dept., DRI-WEFA

that companies must pay above the yield on risk-free U.S. Treasuries have fallen this year.

In addition, declines in the stock market are usually associated with tightening monetary conditions. This time around, though, the Federal Reserve is exceptionally accommodating, and policy is likely to remain stimulative for months to come. That's partly why, despite recent stock market woes, economists believe the recovery remains on solid ground and will accelerate into 2003 (page 110).

ECONOMIC GROWTH this quarter is clearly slowing down its rapid first-quarter clip. But the latest data suggest that the cooler pace is temporary. Steady, if weaker, consumer demand has helped to shrink business inventories to a record low in relation to sales (chart). Inventory rebuilding will support further growth in orders and production in the second half, even as industrial production is already on the rebound. Finally, inventory rebuilding remains surprisingly firm, as further declines in mortgage rates buoy demand.

Be sure, the bear market, if it worsens, creates a

risk for the second half. But the declines so far don't necessarily signal future economic weakness; rather, they point to the soft spot the economy is now in. In this atypical business cycle, fraught with unprecedented risks fueled by geopolitical dangers and mistrust of Corporate America, stock prices have abdicated their usual role as an indicator of future economic activity. Stock investors are taking a very short-term view of the future, which is the chief reason why improving prospects for economic growth and profits are not yet reflected in share prices.

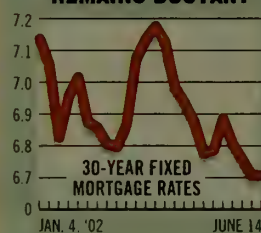
Clearly, the recent market slide has hit consumer confidence. The University of Michigan's sentiment index in early June fell 6 points. And a larger than expected 0.9% fall in May retail sales makes it seem as if consumers are opening up mutual-fund statements and then snapping their wallets shut.

But a closer look at the data shows that consumers are just slowing their spending in the second quarter, not throwing in the towel. For one thing, even with the early-June decline, the Michigan index is at 90.8, a level that historically has been associated with periods of at least moderate growth in consumer spending. Also, first-quarter consumer outlays were boosted by several special factors, most notably tax cuts, auto sales incentives, and unseasonably mild weather. Plus, May's drop in retail sales followed a 1.2% surge in April, and weekly sales surveys through mid-June show a strong rebound.

IF YOU WANT TO KNOW how consumers really feel about their financial future, look at their willingness to commit to a long-term mortgage. By that gauge, consumers are still upbeat. Housing starts in May soared 11.6% from April, the largest increase in seven years. And in June, homebuilders reported that market conditions, based on current and expected sales and buyer traffic through model homes, remain very good.

Why? Because mortgage rates are falling again. By mid-June, 30-year fixed rates slid to an average of 6.7%, the lowest level since the plunge just after September 11 (chart). Rates are declining again because of expectations about when the Fed will begin to lift in-

WHY HOUSING REMAINS BUOYANT



Data: Federal Home Loan Mortgage Corp., DRI-WEFA

Business Outlook

terest rates are being pushed further into the future.

The biggest danger from falling stock prices is the chance of them sapping even more business confidence, which could place an added drag on capital spending. However, business decisions on new equipment and inventories will be governed more by what companies see in their order books and on the bottom lines of their income statements. Those are both improving.

In particular, business inventories have shrunk to levels that assure a significant pickup in reordering. In April, stock levels at manufacturers, wholesalers, and retailers fell 0.2%, the 15th consecutive monthly drop, but sales jumped 1.8%, pushing the ratio of inventories to sales to a low 1.35. That ratio is far below its trend of the past 10 years, suggesting that inventories are generally at less than their desired level.

INVENTORY REPLENISHMENT explains why the industrial sector is on the mend. Industrial production rose 0.2% in May, its fifth monthly increase. So far in the second quarter, output is growing at a 3.2% annual rate, better than its 2.8% advance of the first quarter.

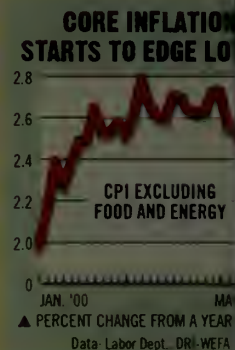
Factory output alone was also up 0.2% in May. Surprisingly, one of the strongest areas of production has been the tech sector, outside of telecom equipment. Output of computer and office equipment, as well as semiconductors, are up at double-digit rates vs. their levels of May, 2001. Thanks to healthy homebuilding,

output of appliances and home electronics are growing solidly. And output increases in industrial materials indicate future gains in production: Factories are low on supplies before revving up their assembly lines.

In the meantime, inflation is following its usual trend by slowing down in the first year of a recovery. Consumer prices were unchanged in May from April, and they are up only 1.2% from a year ago. Core prices, which exclude volatile food and energy, are up 2.5%, down from their 2.8% pace of November, 2001 (chart).

But while low inflation means consumers are able to get more bang for their buck, a lack of pricing power doesn't mean profits necessarily get squeezed. Thanks to productivity gains, companies actually have cut the labor cost of producing each unit of product. That means profit margins are increasing, and any increase in revenues will immediately pump up the bottom line.

Investors have not yet grasped the brighter outlook for both the economy and profits in the second half. That's why life on Wall Street is so dismal now. But will the stock market derail the recovery? For now, at least, the data argue strongly against it.



SPAIN

INFLATION AND LABOR UNREST MAY SPOIL RECOVERY

Spain's economy is showing its poorest performance in five years. While the worst is believed to be over, uncertainty over inflation and labor unrest could jeopardize the recovery.

First-quarter real gross domestic product grew 0.5% from the fourth quarter. Compared with a year ago, real GDP is up 2%, the smallest rise since 1998. For all of 2002, the government expects real GDP to grow by just 2.4%, down from 2.8% in 2001.

Forecasters expect Spain's economy to improve through the course of 2002, but the second quarter is showing scant signs of better health. April industrial production rose by 1% from a down-

wardly revised March. But growth was concentrated in construction-related areas dominated by government pump-priming. Prime Minister José María Aznar hiked public-works outlays by

10.4%, to \$8.2 billion for 2002. Capital-goods production fell 8.1%, a sign that business confidence is still weak.

Although the Labor Ministry said that May jobless claims fell more than expected, job growth was limited to seasonal in-

dustries such as tourism. Meanwhile, the number of job seekers increased. If employment can't be created fast enough, consumer spending, which until now has been resilient, could falter.



The government's attempt to get more people back to work may weaken the labor markets further. Madrid enacted a new measure to cut unemployment benefits to job hunters who retrain in positions that pay less than they want. Unions are protesting loudly. If repeated strikes result, the disruption to business activity could deal a serious blow to business confidence and hiring.

Inflation could also slow the recovery. Spanish consumer prices in May rose 3.6% from a year ago, up from 2.7% in December. And euro zone inflation in 2002 is expected to run above the 2% target set by the European Central Bank. Rising inflation could force the ECB to raise rates by September, creating more headwind for Spain's shaky recovery.

By James Mehrling in New York

WHAT CAN A
T H U N D E R S T O R M
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WHY CORPORATE CROOKS ARE TOUGH TO NAIL

Prosecutors are on the prowl, but given the hurdles they have to clear, convictions may be few

MIKE FRANCE AND DAN CARNEY

The day of reckoning finally seems to be at hand. Emboldened by the criminal conviction of Arthur Andersen LLP for obstruction of justice on June 15, government lawyers are steaming ahead with the Enron Corp. investigation—and are probing malfeasance at an ever expanding list of companies that now includes Tyco International, Adelphia Communications, Computer Associates, and Global Crossing.

As more scandals come to light, the White House is growing increasingly enthusiastic about throwing corporate crooks in jail. Although the Bush Administration is skeptical of new business regulation, it has no qualms about vigorously enforcing existing rules—and is, in fact, on a campaign to convince the public that energetic prosecution is a better way of

coping with America's white-collar crime wave than cumbersome legislation. "Cops who maybe were asleep at the switch when a lot of the abuses were taking place are now aggressively patrolling," says Chief White House Economic Adviser Lawrence B. Lindsey. "Boards of directors and management are now on notice that this is a new day."

So does this mean that the rogue's gallery of irresponsible execs who have populated the business pages over the past several months will finally go to jail? Will the little guy finally be avenged? Don't count on it. While there will certainly be more prosecutions—and some of them will bear fruit—criminal enforcement is a risky game. The laws regulating companies are ambiguous, juries have a hard time grasping abstract financial concepts, and well-counseled executives have plenty of tricks for distancing themselves from responsibility.

The Andersen case underscores the difficulties ahead for the government. The feds almost lost Andersen—even though

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they had an inside whistle-blower, a simple story line, and a hometown jury packed with people who had seen the devastation Enron caused close-up. "After Arthur Andersen, nobody is going to talk about slam-dunk cases anymore," says Columbia University Law School securities law professor John C. Coffee.

What's more, many of the abuses that have enraged the public are entirely legal. Companies can file misleading accounting statements that are in complete compliance with generally accepted accounting principles (GAAP). They can boost their income, for example, simply by assuming that their pension plan investments will earn a higher rate of return in the future. Executives are also allowed to enjoy outrageous incomes and baronial perks without breaking any laws at all—so long as the board approves. And because so many of the laws governing corporate conduct are weak, there's no way criminal or civil prosecution can ever be a complete substitute for regulatory reform—no matter how aggressive the White House promises to be. "Enforcement works for the tiny percentage of people who engage in truly egregious behavior," says Henry T.C. Hu, a corporate and securities law professor at the University of Texas. "But for the far more numerous instances of lesser behavior, it is hard to reach them through enforcement."

Of course, the fact that criminal law applies only to extreme cases is probably little comfort to those under scrutiny. In the wake of the Andersen victory, government lawyers are turning their attention to the biggest target of all: Enron. Using their verdict against the energy giant's auditor as leverage, they're hoping to win the cooperation of insiders and build a case against top executives Kenneth L. Lay, Jeffrey K. Skilling, and Andrew S. Fastow (page 38). Enron and the individual officers all deny they've broken any laws.

Many of the scandals that have emerged since Enron are also on the government's radar screen. Criminal charges have already been leveled against former Tyco CEO L. Dennis Kozlowski for tax fraud and former ImClone Systems Inc. CEO Samuel D. Waksal for insider trading. Both claim they are innocent. Meanwhile, several other companies and their executives, including Global Crossing and Adelphia, are under investigation.

Sensing the public's anger, law enforcers across the country are taking a new interest in corporate crime. While most federal securities fraud suits have historically been filed by U.S. Attorneys in Manhattan and Brooklyn, cases are currently pending in an unprecedented 17 offices, ranging from San Francisco to Miami to Alexandria, Va. State and local prosecutors, such as New York State Attorney General Eliot Spitzer and New York City District Attorney Robert Morgenthau, are also getting in on the act. "In the aftermath of Enron, it is becoming easier to interest criminal prosecutors in complex securities cases,"

says Stephen M. Cutler, director of the Securities and Exchange Commission's Enforcement Div., which lacks the authority to file its own criminal prosecutions. "Their reluctance in the past came from a fear that these cases wouldn't well...in front of juries."

As it turns out, that fear is not entirely unfounded. In the current flurry of activity may not necessarily yield a string of convictions. In a country with a long-established tradition of criminal rights, prosecutors always face high hurdles. They must, for starters, prove their cases beyond a reasonable doubt. In business cases, they also have to educate jurors about sophisticated financial concepts. That's no small job. Andersen should have been a prosecutor's dream: a clear-cut case of obstruction of justice where no one disputed that real documents had been destroyed. But the prosecution unraveled under the skilled counteroffensive of the de-

The Legal Road Ahead

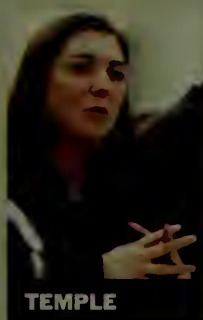
In the wake of the Andersen guilty verdict, the government is gearing up to go after top executives, and possibly corporations, on charges involving everything from insider trading to perjury. All of the targets deny wrongdoing, and winning convictions won't be easy.

Some companies and executives already face criminal prosecution...

ARTHUR ANDERSEN

CHARGE Obstruction of justice

KEY ISSUES After the June 15 collapse of the partnership, the spotlight moved to potential cases against individuals. Company counsel Nancy Temple, whose memo was the basis for the verdict, had been identified by Justice Dept. as a "target," and others may follow.



TEMPLE

TYCO INTERNATIONAL

CHARGE Tax evasion

KEY ISSUES The probe into Tyco International has expanded dramatically since former CEO Kozlowski was indicted on June 4 on charges that he evaded more than \$1 million in New York State sales taxes on some \$13.2 million of art. Since then, both the Securities & Exchange Commission and outside counsel hired by Tyco have begun a broad probe into possible misuse of corporate funds by senior executives, including Kozlowski and former general counsel Robert Belnick. The SEC is also looking at Tyco's accounting.

tyco

IMCLONE

CHARGE Insider trading

KEY ISSUES Former CEO Samuel D. Waksal was indicted on June 4 by federal prosecutors in New York on charges that he tipped off friends and family that the company's & Drug Administration would reject its application for approval of a new drug, Erbitux. The company had expanded to include people Waksal co-



FORMER IMCLONE CEO WAKSAL

WHAT WILL HELP *Because laws on corporate conduct are weak, it will take serious regulatory reform to prevent future abuses*

just getting jurors to understand the basics can be a challenge. According to one news report, an Andersen juror initially believed that the case involved the National Aeronautics and Space Administration.

Imagine how much harder it would be to teach jurors about special-purpose entities or complex derivatives, as the prosecutors in any potential case against Enron would probably have to do. That's why government lawyers will try to keep clear of arcane minutiae, stick to clear themes, and to pose their arguments as simple human morality tales.

...while others remain under the microscope

ADELPHIA

ADDITIONAL CHARGES Securities

QUESTIONS Grand juries in New Jersey and Pennsylvania are looking for evidence of unconventional transactions benefiting the founding family. These include transactions on an off-balance-sheet company, the family and the founding of a golf course in Pennsylvania.

None were approved by the board. The company denied culpability and has launched its own probe.



EX-ADELPHIA CEO JOHN J. RIGAS

ENRON

ADDITIONAL CHARGES Securities fraud, insider trading, and perjury

QUESTIONS The activities of former CFO Andrew Fastow are at the center of the investigation. Whether Enron partnerships were designed to win a conviction, the Justice Department would have to show that the partnerships were designed to defraud investors by hiding Enron's precarious finances. Prosecutors are also looking at sales of Enron stock by insiders, including former Execs Lay and Skilling, and whether Skilling lied to himself in his congressional testimony.



GLOBAL CROSSING

ADDITIONAL CHARGES Insider trading, securities fraud

QUESTIONS The FBI and the SEC are looking at Enron's capacity on the company's fiber-optic network. The feds are investigating whether these deals misleadingly hiked the company's revenues. Swaps were also allegedly practiced by telecommunications and energy traders such as Enron. The SEC is also looking at insider sales of Enron stock in Global Crossing stock by company Chairman Gary Winnick.



WINNICK

"What you really need to win any of these cases is an insider who can recount the conversations people were having and explain what people were thinking," says New York litigator Richard A. Martin, a former Assistant U.S. Attorney.

Finding such a whistle-blower is tough. Enough evidence has to be marshaled to persuade an insider to cooperate and then turn on his or her associates. And that's not the biggest challenge. To win a criminal case, prosecutors have to prove that an exec willfully broke the law—that he or she knew, for example, that the 10-K was fraudulent. If the executive has any legitimate reason for believing that the document was accurate, no matter how implausible, criminal charges will fail. In contrast, the plaintiffs in a civil lawsuit would have to prove only that the exec was reckless about the legitimacy of the 10-K—that he or she should have been aware it was misleading.

Big companies have lots of lawyers, and these lawyers specialize in creating exactly the type of paper trail that will exonerate top execs. Aggressive actions are routinely fortified with sanitizing formalities: file memos that justify iffy decisions, board approvals, and blessings from outside lawyers and accountants. Even if they helped nurture a corrupt corporate culture, CEOs and CFOs can often plausibly claim that they knew nothing about wrongdoing three or four levels down the hierarchy. All of these factors help to create the type of reasonable doubt that kills criminal prosecutions. In the Enron case, Lay, Skilling, and Fastow are all likely to argue that the company's disclosures were approved by Andersen. "They're going to say, 'Look, I'm not an accountant. I told them what I wanted to do, and they said it was O.K.,'" says Houston criminal and civil defense attorney David Berg.

The difficulty of proving what's going on inside an executive's head makes it hard to prosecute cases where the law is unclear. The more ambiguity there is, the easier it is for execs to plead ignorance. As a result, government lawyers may have a tough time pinning blame on corporations and individuals in cases focusing on new types of derivatives, complex tax dodges, and exotic partnerships and joint ventures. That's a broad category that could include many recent accounting controversies, including the off-balance-sheet partnerships used by companies such as Enron and PNC Financial Services Group Inc.

Still, despite the obstacles, public anger is on the rise, so prosecutors are likely to keep the heat on. Jail is the best way ever invented to grab executives' attention. A busy CEO can buy insurance to cover legal damages. But there's no way to hire someone to serve jail time. And prison can't be counted as a business expense. Had government lawyers been more aggressive about bringing criminal cases a decade ago, says Joel Seligman, a securities expert at Washington University School of Law, many of the recent abuses might never have occurred. "Fraud is not a steady-state phenomenon," says Seligman. "It's binge and purge. What has become absolutely clear is that the late '90s were a binge period—in part, because the sensitivity to prosecution was reduced." That sensitivity is increasing. What's not clear, though, is how effective the coming purge will be.

With Mike McNamee and Amy Borrus in Washington

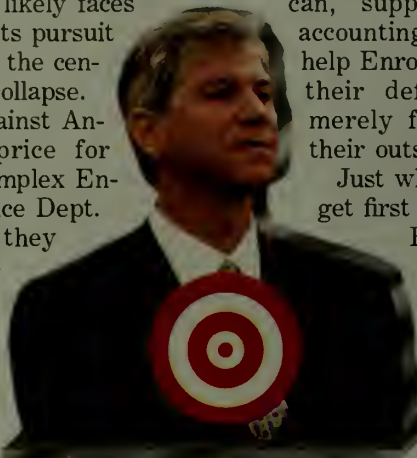
THE PRICE OF VICTORY OVER ANDERSEN

It's a mixed bag as Justice pursues Enron execs

Federal prosecutors won't have long to relish their hard-won victory over Arthur Andersen LLP. For all the talk of "momentum" after the June 15 guilty verdict on an obstruction of justice charge against the accounting firm, the government likely faces a long, tough slog in its pursuit of the main culprits at the center of Enron Corp.'s collapse.

Indeed, the win against Andersen came at a price for Washington's more complex Enron cases. While Justice Dept. officials contend that they have been moving forward with their En-

FASTOW: His off-balance-sheet deals put him at the center of the investigation



ron investigations even as they pursued Andersen, the trial certainly stretched the department's resources and the attention of top officials. Legal experts figure that it could be months before there are any indictments, especially in light of the difficulties that the government had with what many considered a slam-dunk case against the accounting firm. Says Philip H. Hilder, who represents Enron whistle-blower Sherron S. Watkins: "Because of the complexity of the Enron investigation, I would not anticipate indictments being returned until late summer or early fall at the earliest."

The Andersen case was not only time-consuming but also a mixed bag

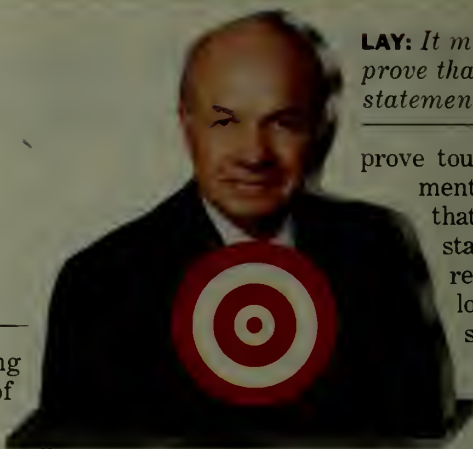
in terms of advancing Justice's chances of successfully taking on Enron. The prosecution's star witness, for instance, former Andersen partner David B. Duncan, supported the aggressive accounting at Enron. That could help Enron executives to argue in their defense that they were merely following the advice of their outside accountants.

Just whom prosecutors will target first at Enron is a tough call.

Former CFO Andrew S. Fastow and former CEOs Jeffrey K. Skilling and Kenneth L. Lay could all be feeling the heat. Securities fraud, insider trading, mail and wire fraud, and perjury are all potential

charges. Still, "the person who has got the biggest problem here is Fastow," says one lawyer close to the case. Another calls Fastow the "hub" of Justice's investigation. That's because the ex-CFO, who made some \$45 million from off-balance-sheet deals, appears to be the main architect of the complex structures that led to the downfall of the energy-trading giant. In some instances, Skilling and Lay have claimed that he acted without their knowledge. Fastow's lawyers would not comment.

Cases against Lay and Skilling could



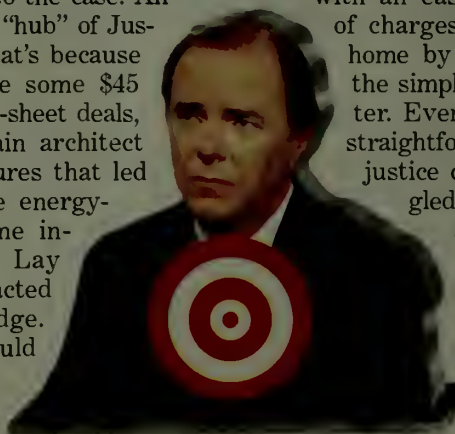
LAY: It might be difficult to prove that he knew false statements were incorr

prove tougher, as the government will have to prove that they knew false statements were incorrect. Justice is looking at their sales and is examining Skilling's congressional testimony for perjury. Says

lawyer close to Andersen: "A case against Lay is going to be difficult." Because ex-Enron chief "is operating at a level of generality," his direct involvement in any wrongdoing is hard to prove.

That's why prosecutors will proceed after the little guys first. The Justice Dept. isn't talking, but former prosecutors and lawyers close to the Andersen and Enron cases suspect that Justice will follow a tried-and-true approach: first gaining guilty pleas and cooperation agreements with lower and mid-level Enron employees, then working their way methodically to the top. "You have to be an insider to interpret the facts of the case," says Stephen M. Ryan, a partner with Manatt, Phelps & Phillips. "I will pursue him and you flip him."

All the witnesses in the world will help, though, unless the feds come up with an easy-to-understand set of charges. In a point-by-point breakdown by the Andersen lawyers, the simpler the case, the better. Even with the relatively straightforward obstruction of justice charge, jurors struggled for 10 days to reach a verdict. That's why legal experts



SKILLING: His congressional testimony is being checked for perjury

GOING AFTER ENRON

THE ANDERSEN VERDICT COULD HELP THE GOVERNMENT BY:

- Highlighting information that top executives hid from Enron auditors or the board
- Reinforcing the need for Justice to make its case in clear and simple terms

BUT IT COULD ALSO HINDER THE GOVERNMENT BY:

- Supporting Enron executives' defense that they relied on Andersen advice
- Convincing potential defendants that there is little need to cooperate with the government

expect Justice to pursue cases where there were clear conflicts of interest. Enron insiders, for instance, profited from the off-balance-sheet entities at the expense of shareholders' expense and hiding information from the auditors and the board.

With one guilty verdict in hand, the feds are eager to move on to Enron. But given how hard it was for Justice to win, the outcome of the Andersen trial could provide the government as much worry as momentum.

By Wendy Zellner in Dallas, Dan Carney in Washington



ANDERSEN

LONG: *The entire firm is paying for the misdeeds of some, as offices around the globe are closed*

COMMENTARY

By Joseph Weber

THE LINGERING LESSONS OF ANDERSEN'S FALL

Is it all worth it? An acrimonious six-week trial. A guilty verdict that turned on a single e-mail. Disruptions for hundreds of corporations in the middle of a season. Maybe a jail term for the individual targeted—so far—by the government. And the fall of one of the world's leading accounting firms, wiping out or eliminating thousands of jobs. Are we better off after all the chaos wrought by the prosecution of Andersen LLP?

Of course, yes. The government's decision to go for the jugular was a win, but its win will have far-reaching, beneficial effects. The next time an attorney hints that staffers are shredding documents as investigators close in, a fool will follow the suggestion. When an overbearing corporate lawyer urges an auditor to sign off on dubious financial statements, even the most obliging will likely stiffen their resolve. And auditors and clients whose relationships have gotten too cozy are on notice that they have to take some professional distance from one another. By pushing for criminal charges, the Justice Dept. has raised the stakes too high for anyone to ignore. (For a different view, see editorial on page 142.)

Of course, the verdict could still be overturned on appeal. But the lessons of Andersen's fall go well beyond the government's narrow victory. Consider

the root problem: Andersen brought its woes on itself with a series of sloppy audits for Sunbeam, the Baptist Foundation of Arizona, and most damningly, Waste Management. Those botch-ups cost investors hundreds of millions of dollars. The Waste Management Inc. errors led to a crucial antifraud injunction against the company and a promise to avoid poor practices—a promise prosecutors claimed Andersen broke with Enron Corp. audits. The lesson: Redouble efforts to ensure every audit is flawless. Don't slight auditing in favor of lucrative lures, such as consulting.

If that sounds obvious, well, that's just the point. Clearly, the Andersen debacle shows how deeply the accounting industry has lost its way. The same can be said for the legal profession. Think attorney-client privilege gives you the right to aid in a coverup? Nope. As the jury made unequivocally clear, Andersen attorney Nancy Temple had no business telling auditor David B. Duncan to delete critical language in a memo on an Enron earnings statement last fall.

It's now obvious that Temple, who cited the Fifth Amendment as she declined to testify, shouldn't have told Duncan to mute hints that the statement was misleading. As the government showed, she had reason to believe investigators were hot on the trail. Minor technicality? Routine legal editing? Hardly—it was a blatant ef-

fort to avoid Securities & Exchange Commission scrutiny. "It's rudimentary," says Joseph E. diGenova, a former U.S. Attorney for the District of Columbia. "This is a simple issue of honesty. It's almost an Aesop's fable."

To be sure, the Andersen case was messy. Short of evidence to pursue individuals beyond Duncan, the government took the broadest swipe possible and indicted the entire firm, tarring innocent staffers. And ultimately, the jury set aside most of the government's accusations, even largely disregarding the shredding efforts the government had made so much of.

Yes, the government could have prosecuted more skillfully. But that doesn't change that misdeeds were done and laws broken. Serious audit failures and a subsequent inability to correct what led to them were followed by the misguided acts of a few staffers desperate to hide misdoings.

It's too bad the entire firm had to pay for such errors. But its leaders lacked the discipline, gumption, or insight to fix Andersen's flaws. With any luck, the ex-partners and staffers won't take the bad habits with them as they move on. Prosecutions are vicious affairs, but stiff penalties are sometimes the only way to force people back onto the straight and narrow.

Chicago Bureau Chief Weber covers Andersen.

MORE FUNNY BUSINESS *The government's pursuit of Andersen is a wake-up call to auditors everywhere, no matter how big their firm*

THE TAX GAMES TYCO PLAYED

It made an art form of avoidance, but a climate shift has opened the door to harsher scrutiny

The criminal indictment of L. Dennis Kozlowski paints a stunning portrait of complex schemes the former chief of Tyco International Ltd. allegedly used to evade New York State and City sales taxes on \$13.2 million worth of personal artwork. To beat the 8.25% tax, the June 4 indictment charges, Kozlowski and his co-conspirators used such tactics as preparing false invoices and shipping empty boxes to the conglomerate's executive offices in New Hampshire.

That scheme was child's play compared with the apparently legal methods Tyco has used to avoid corporate income taxes. Under Kozlowski, tax avoidance became a way of life and a key corporate strategy. It's not just that Tyco five years ago moved to the now-famous tax haven of Bermuda. Since then, it has gone to extraordinary lengths to amass subsidiaries in such tax-friendly locales as Barbados, the Cayman Islands, and Jersey. From 2000 to 2001 alone, the number doubled to more than 150.

The payoff: Tyco has cut its effective tax rate from 36% in 1996, just before the Bermuda move, to 23% in 2001. In an interview last year, Tyco Chief Financial Officer Mark H. Swartz said tax stratagems would slash Tyco's 2001 tax bill by some \$600 million. "It has been a huge strategic advantage," he bragged.

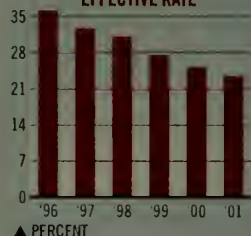
Yet Tyco didn't actually pay anything near even that 23% rate, according to Bob McIntyre of Citizens for Tax Justice, a Washington advocacy group. Why? That rate was based on Tyco's

"provision" of almost \$1.5 billion for income taxes. But in its 2001 10-K, Tyco admits only \$754 million was considered due in that year. Of that, \$629 million was said to be for non-U.S. income taxes. The company doesn't spell out exactly how much of the remainder covers U.S. taxes, but the amount would be reduced further by a deduction for millions of execu-

tive stock options that were exercised. McIntyre says Tyco may have wound up paying nothing: "Was [the U.S. tax bill] positive? Probably not."

Suddenly, though, Tyco's powerful advantage is coming under scrutiny. And it couldn't happen at a worse time for the \$36 billion company, which is scrambling to avoid a liquidity squeeze. In Congress, which for years showed little interest in this issue, Tyco has become the No.1

TYCO'S INCREDIBLE SHRINKING TAX BILL
EFFECTIVE RATE*



*FOR FISCAL YEARS ENDING SEPT. 30
Data: Company filings



example for those seeking to re tax strategy many consider unpai "Tyco has raised tax avoidance art," grouses Rep. Richard E. Ne Mass.), who has introduced legi that would force Tyco to pay tax U.S. corporation beginning in 20

That perception, along with Kozlowski's indictment, makes it more that tax authorities in the U.S. and other high-tax industrialized countries put Tyco's tax schemes under a microscope. The basic strategies "are consistent with the tax code and regulations," says one Wall Street expert. However, because a number of Tyco's subsidiaries appear to exist only to deal with related units, that could be challenged by the Internal Revenue Service. "Tyco is an obvious audit target," argues Leslie B. Samuels, a



Wish You Weren't There

Washington rarely cracks down on corporate tax avoidance scheme—companies' ability to cut taxes by moving headquarters to havens like Bermuda—is generating bipartisan criticism because tax avoidance was a key element in scandals at companies as Enron and Tyco, and a wave of companies such as Stanley and Ingersoll-Rand have made moves to relocate. Pro-business Republicans are resisting the curbs, but on June 18, the Senate Finance Committee agreed to back them. Chances are that Congress will limit such deals, at least temporarily. The altern



SHELTERED EXISTENCE

More than five years ago, Tyco set up shop in Bermuda (far left), where lower taxes led to "a huge strategic advantage," bragged Swartz (center). Kozlowski allegedly used the company's New Hampshire offices (above) to avoid paying taxes on \$13.2 million of personal artwork.

tax attorney and former U.S. assistant Treasury secretary for tax policy. Tyco first began to focus on tax avoidance in 1997, when Kozlowski bought ADT Ltd., a security-services firm. ADT—headed by the controversial Michael A. Ashcroft, now a member of Tyco's board—already was based in Bermuda. Through a reverse merger, which the smaller ADT effectively acquired Tyco, Tyco no longer had to pay taxes on its non-U.S. income.

The biggest savings, though, came in the following years. Many of the tax-haven subsidiaries Tyco owns—with such names as Silver Avenue Holdings, Driftwood, and Bunga Bebaru—have little apparent connection to its operating businesses. But they are perfect vehicles for shielding interest, dividends, royalties, and other forms of passive income

from tax," says Samuel C. Thompson Jr., a professor at the University of Miami School of Law. In fiscal 2001, Tyco reported that while 65% of its revenues came from the U.S., just 29% of its income did. In other words, 71% was no longer subject to the 35% U.S. corporate income tax. A Tyco spokesman declined to discuss the company's overall tax policy. He said many of the subsidiaries "are dormant" and some are being dissolved.

Tyco's 10-K provides no information about the operations of most of these mysterious subsidiaries. But tax experts point out that the units could be used to engage in transfer pricing. Goods produced in a high-tax country might be sold to a tax-haven subsidiary for a low price, and then legally resold at a higher price—with most of the profit tax-

free. Clearly, one of the most important overseas units is Luxembourg-based Tyco International Group. TIG borrows much of the billions Tyco needs to finance its \$27 billion of debt, and then reloans it to Tyco units in the U.S. and other high-

tax countries. In its 10-K, Tyco reported that TIG had \$16.7 billion in such intercompany loans outstanding. The beauty of this is that the interest Tyco's U.S. subsidiaries pay on these intercompany loans is tax-deductible in the U.S. Moreover, Samuels says TIG could be charging Tyco's other subsidiaries a higher interest rate than it is paying—further increasing the tax benefit. But the interest payments Tyco's U.S. units ship back to TIG are not taxed in Luxembourg, says Robert Willens, a Lehman Brothers Inc. tax analyst.

At least one of Tyco's overseas units has come under official scrutiny. Earth Tech Venezuela was formed in 1999 to handle a \$200 million contract a Tyco unit had won to build and operate an industrial water-treatment complex in that country. In a deposition taken last December as part of a labor dispute lawsuit involving a disgruntled former executive, Charles S. Alpert, general counsel of U.S.-based Tyco subsidiary Earth Tech, testified that "on the advice of the Tyco tax department," Earth Tech Venezuela was set up so it was owned by Luxembourg-based Tyco Group. Such a move would shield the Venezuelan project from U.S. taxes.

Now, *BusinessWeek* has learned that the Securities & Exchange Commission is investigating whether Earth Tech may have used means to win the contract—such as paying bribes—that would violate the Foreign Corrupt Practices Act. Miguel Delgado Bello, a vice-president for Earth Tech Venezuela at the time of the bid, says that in mid-May he met with SEC investigators to discuss bribes he alleged were paid by the Tyco unit to seal the deal. But Tyco points out that Delgado, fired later in 1999, was thoroughly discredited in a May 15, 2002, U.S. District Court ruling that found he "has given false testimony [and] fabricated documents...in an effort to perpetuate a fraud on the court." Nonetheless, sources say the SEC is still probing the bribe allegations.

Some tax experts suspect if the IRS fully probed Tyco's bag of tax tricks, the company could be hit with huge penalties, because it could argue Tyco's tax situation doesn't reflect economic reality. Since Kozlowski's resignation, Tyco has strived to argue that his personal conduct will have no material impact on the company. But Kozlowski's legacy also included an increasingly aggressive strategy of avoiding taxes by any means possible. That may prove to be an even bigger problem for Tyco.

By William C. Symonds in Boston, with Geri Smith in Caracas, Venezuela

House Democrats, led by Representative Richard E. Neal (D-Mass.), favor this approach.

President Bush wants to limit tax benefits for foreign parents of U.S. companies. Key senators would slow, but not block, the deals.

House Republicans, led by Ways & Means Committee Chairman Bill Thomas (R-Calif.), prefer to enact broad changes in international tax law—though that would be years away.

Many lawmakers believe a temporary ban on tax benefits for Bermuda-based companies would be a good compromise.

COMMENTARY

By Mike McNamee

THE SEC CAN'T GUARD THE HOUSE ALONE

Ever since the Enron Corp. scandal broke last fall, Securities & Exchange Commission Chairman Harvey L. Pitt has insisted that the SEC can clean up Corporate America all by itself. Whether it's based on confidence in his agency or on the Bush White House's desire to contain any political fallout from the scandal, Pitt's strategy has been to work around, rather than with, Congress on badly needed reforms.

But the June 20 unveiling of his proposal for a new accounting-discipline board shows that Pitt has hit the limits of that approach. To give the new board teeth, Pitt is proposing a jury-rigged scheme that's likely to collapse the first time it is challenged in court. Instead, Pitt should seize the momentum that's building with the Senate Banking Committee's June 18 passage of an accounting-reform bill and work with Congress to establish the sound accounting regulator that investors need to restore confidence in Corporate America's books.

Certainly, Pitt stunned accountants and their lobbyists by proposing a stronger than expected Public Accountability Board (PAB). The PAB would have broad powers to investigate auditors' lapses in skills, ethics, or independence. The board could censure or fine individual CPAs or their firms and remove them from a particular audit—or bar them from auditing altogether. Its funding—from companies as well as accounting firms—would be more reliable and independent than that of past accounting overseers.

But the crucial issue is how a disciplinary board for accountants will impel companies to cooperate with investigations of failed audits. To get to the heart of audit breakdowns, the board needs to hear from corporate officers—even if they don't want to talk. To do that, the new board must be able to subpoena witnesses and documents. The Senate bill lets the discipline board request an SEC subpoena, but Pitt's PAB wouldn't even have that power. Only Congress can extend that power, and Pitt is

avoiding Congress. Why? Like the White House, he believes that controlling the outcome of any legislative effort would be difficult. He argues, too, that giving the board subpoena power will make it a government agency, burdening it with budget limits and legal procedures that will hamper its crack-down on accountants.

So Pitt has come up with another plan: He would require every public

company in America to sign on as "adjunct member" of the PAB, thus committing to its oversight. If a company balks at cooperating with the PAB, SEC would refuse to accept its financial reports, thereby shutting the company out of public capital markets.

It's a clever scheme, but also "a squirrely—obviously an end run to give government power to a non-governmental entity," says Adam Pritchard, a University of Michigan professor and former SEC lawyer. A private membership organization, the PAB would exercise its powers with the safeguards of legal procedures and court review that the SEC and other agencies must follow. Companies are likely to surrender those protections.

"It's a clear target for a court challenge," says Stanley Keller, chairman of the American Bar Assn.'s panel on SEC matters. SEC officials in the plan would withstand any such challenge. If they're wrong, a loss would gut Pitt's board even before it got started.

The PAB proposal has other problems. Pitt's board would have one full-time director (a chairman or vice-chairman) and eight part-timers. A nine-member board could well be unwieldy, part-timers are more likely to resent their own industries, not investors' interests. While CPAs would get only three seats, their expertise would give them an enormous advantage over the board's other part-time members.

Neither the SEC nor the White House would appoint the board members. Instead, they expect accountants, corporate leaders, and investors to create a board for the SEC's approval. While the agency will monitor the process, it's a backroom deal.

But none of that will matter if the board lacks the power to sue its probes. It can have that power—if Congress establishes the board by law. It's time for Pitt to work with Congress, not bypass it, to give America's investors the accounting and audit system they deserve.

With Amy Borrus in Washington



This Watchdog Could Use More Bite

BOARD MAKEUP Pitt's proposed nine-member board would be unwieldy and unlikely to attract top talent, and it is unclear who would appoint members. A smaller board, named by financial regulators, would be more effective and independent.

INVESTIGATIVE POWERS Pitt's scheme to obtain documents from companies with failed audits isn't likely to survive court challenges. Subpoena power is needed.

AUDIT STANDARDS Under the plan, the CPAs' professional organization may retain power to write rules for how auditors do their work. The new board should establish its own standard-setting group.



is it the wireless
infrastructure?
the wireless
enterprise?

or just a lot
of really
pertinent data.

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SORTING OUT THE MARTHA MESS

The latest CEO to become entangled in the widening series of corporate scandals is Martha Stewart, founder of Martha Stewart Living Omnimedia Inc. America's most celebrated homemaker has become the subject of screaming headlines and messy questions into her stock trading. The U.S. Attorney General for the Southern District of New York, along with the Securities & Exchange Commission and the House Commerce & Energy Subcommittee, are trying to figure out whether Stewart is guilty of insider trading after dumping her 3,928 shares in the tiny biotech ImClone Systems Inc. one day before the stock plummeted on bad news. The scandal has sliced more than 13% off the stock price of Omnimedia since June 6, when news broke of its founder's lucky timing. Here are some of the questions surrounding Stewart's trading:

Why is Stewart under investigation when other people also sold stock on that day?

Not only is she a good friend of former CEO Samuel D. Waksal, who faces criminal charges of insider trading, but her broker is a former ImClone employee who also has Waksal's daughter Aliza as a client. Aliza is one of several family members who allegedly sold stock before Stewart dumped her holdings on Dec. 27. Stewart could face charges if a company insider tipped her off to impending news and she acted on that information. She could even be guilty if the broker passed along inside information that she knew or should have known came from Waksal.

Stewart says she told Merrill Lynch & Co. broker Peter Bacanovic in late November to sell if the stock went below 60, but he allegedly told investigators that the discussion took place in mid-December. Why does the timing matter?

Stewart's defense is much stronger if she issued the order in November. By early December, some ImClone officials became aware that the Food & Drug Administration might not accept the application for approval of their much-awaited cancer drug Erbitux, and

could have alerted her to that fact.

Where is Bacanovic, and why hasn't he come to his client's defense?

He was in Britain as the tabloids hurled mud at Martha in recent days, but sources say he's now back in the U.S. He has cooperated with investigators and is due to meet with congressional officials during the week of June 24. Still, don't expect many public state-



STEWART WITH MERRILL LYNCH BROKER BACANOVIC

ments or interviews while the investigation is under way.

What kind of evidence is needed to press charges against Stewart?

Investigators need concrete proof that either Bacanovic or an ImClone insider relayed information to Stewart about the impending FDA announcement. That could come through some documentation of telephone calls with her broker or evidence of direct contact with Waksal before the sale. Stewart admits to phoning Waksal after ordering the stock sale but says he never called her back. Indeed, some investigators already doubt they will find enough to make charges stick.

Aren't phone calls with brokers taped?

The only calls that are routinely taped are to and from brokerage trading desks. While brokers may request to be taped, it's not standard practice. Merrill Lynch, where Bacanovic works, said it does not comment on either client relationships or ongoing investigations.

However, Bacanovic may have written notes that document Stewart authorized the sale. She already said there was no formal "loss" order, just a verbal agreement. Without a record of what transpired between the two—and when it took place—there's little proof to convict.

Is it likely that Stewart is telling the truth and simply had brilliant timing?

It's certainly possible. One thing, the stock had a significant runup in November and was in a volatile sector. It had already started to slide when rumors of trouble with the company's application surfaced in the weeks before Stewart sold off her holdings. Investigators will have to ask why she would have simply sold in mid-November if she got wind of a possibly devastating FDA ruling. Another basic question: Why would a woman worth more than \$500 million risk everything for a payout of less than \$230,000? As a former stock broker and CEO of a public company, Stewart knows the rules surrounding insider trades. Investigators have to prove she ignored the risk of getting caught for a relatively small

Is this controversy likely to hurt her \$300 million media and retail empire?

Investors are skittish, but consumers may not care. They read Stewart's magazine, watch her TV show, and buy her products for the lifestyle they project. That could change, of course, if the maverick icon actually faces a criminal conviction.

Not only has the company weathered an ad drought and the recent bankruptcy of Kmart Corp., its founder is already one of the most skewered and parodied CEOs in history. Laura Richardson, vice-president for equity research at Boston's Adams, Harkness & Hill, thinks this scandal will blow away like a soft lemon sorbet. "Without ImClone, she says, 'everybody in America has heard some negative story about Martha at this point.'"

By Diane Brady, with Emily Thornton in New York and Mike McNamee and Amy Borrus in Washington



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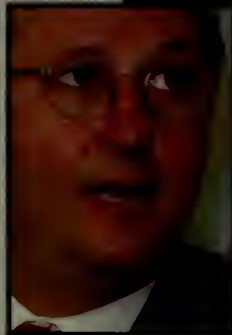
'WE CAN'T BE ALL THINGS TO EVERYBODY'

Notebaert's blueprint for Qwest: Simplify, simplify

Richard C. Notebaert said it took him all of a "nanosecond" to accept the job as chairman and chief executive of Qwest Communications International Inc., the troubled telecom giant. Indeed, Notebaert was so quick to accept the position that he didn't consult his wife before accepting, even though the new job would likely involve moving from the couple's Chicago home to Qwest's headquarters in Denver. "In hindsight, it would have been wiser to ask her," Notebaert says.

Wall Street, too, had a quick response to Notebaert's June 17 hiring and the simultaneous resignation of his predecessor, Joseph P. Nacchio: Qwest's stock jumped 20% that day. But fixing Qwest won't be as simple as bringing in a new CEO. Bluntly put, Qwest is a mess. The company is groaning under the weight of \$26 billion in debt. It has \$3.4 billion of that coming due next May, an amount the company will not be able to cover from its operations. Two major credit rating agencies think the prospect of bankruptcy is likely enough that they downgraded the company to "junk bond" status in May. "It's a precarious situation," says Catherine Cosentino, a telecom analyst at rating agency Standard & Poor's, which, like *BusinessWeek*, is a division of The McGraw-Hill Companies.

Notebaert is beginning to articulate his plan for putting Qwest on more solid footing. In an interview with *BusinessWeek*, the 54-year-old telecom veteran suggested that he will accelerate previously announced asset sales to generate the cash necessary to pay off the debt coming due. More surprising are his plans for Qwest's money-losing fiber network. Pundits have speculated that Notebaert, who was chief executive of local-phone giant Ameritech before selling it to SBC Communications in 1999, would abandon Nacchio's cherished fiber network to focus on the local-phone



DIRE STRAITS

Taking over from Nacchio (left), Notebaert wants to speed up asset sales to pare down \$26 billion in debt

business that Qwest acquired in its purchase of US West. But Notebaert says he may simply narrow the operation's focus, concentrating on smaller companies in key cities rather than the multinational corporations that Nacchio targeted. "We can't be all things to everybody," says Notebaert. "I really believe there's an opportunity in small to medium-size businesses."

Improving Qwest's balance sheet is his most urgent task. An auction for the company's Yellow Pages business has been hung up by certain state reg-



ulators who argue that local customers are entitled to see the proceeds. Notebaert says he will accelerate that sale, which will bring in more than \$8 billion, possibly by selling the business in chunks starting with the states in which there's no regulatory opposition. Notebaert also indicated that he will sell the company's phone business, which could bring in \$1.5 billion more.

He has no time to waste. The covenants on Qwest's bank loans tighten at the end of this year. If it doesn't close the Yellow Pages sale by December, it probably will be in violation of the new terms. Qwest will have to renegotiate with its banks or risk being in default.

Of longer-term concern to Wall Street is the fate of Qwest's 100,000 miles of fiber-optic lines, once the centerpiece of the company's strategy to offer high-end voice and data services to large companies.

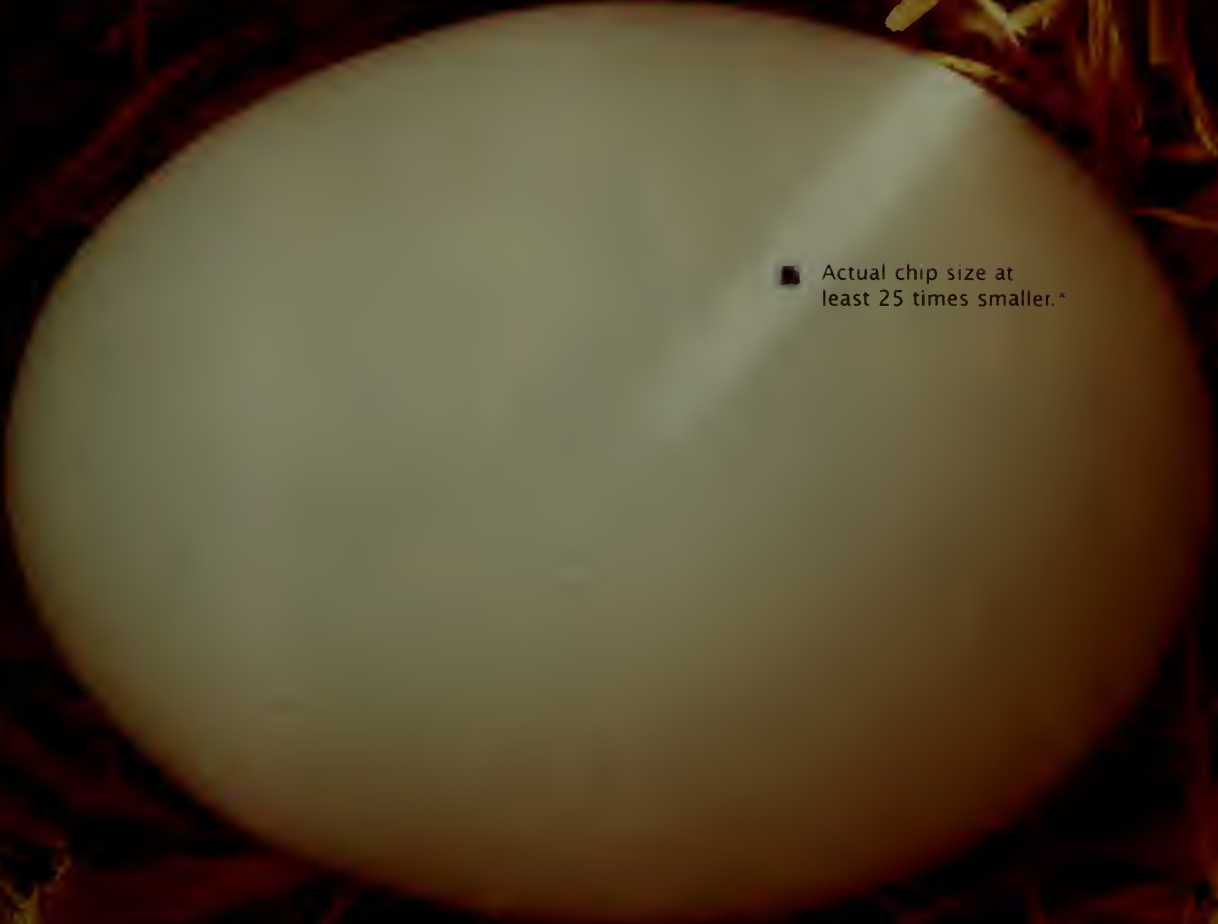
The network, which is losing more than \$500 million a year, by some estimates is considered a liability that some investors believe Qwest would do better to sell or spin off. Instead, Notebaert says he is considering exiting international markets, focusing on a few domestic cities, and targeting niche markets. "Our approach should be like a shotgun and more rifle," he says.

There are doubters. "I'm not sure Qwest's network will ever have the scale to compete against AT&T, Verizon, and Sprint," says Blaikie K. Kline, a telecom analyst at the consulting firm Adventis Corp. "There has to be consolidation in the future."

Although Notebaert sold Ameritech, he says he plans on running Qwest for the while. He says that his wife, Peggy, already found two houses in Denver that she likes. Now, if only he can get Qwest shareholders as happy.

By Christopher Palmeri in New

SMALL WONDER



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COMMENTARY

By John A. Byrne

INVESTOR POWER HAS ITS DOWNSIDE, TOO



Many of the corporate governance reforms now being actively debated would help shift some power back to shareholders from management. And in light of the way many chief executives have run their companies into the ground of late, piling up tens of millions in pay, stock gains, and severance even as investors get pummeled, giving shareholders more clout seems like a good idea. But try to imagine, for a moment, what would happen if institutional investors had far more influence over the management of public corporations. Would CEO pay get ratcheted down to more sensible levels? Would boards of directors truly become independent fiduciaries of the shareholders? Would the investment horizons of managers become shorter or longer?

The short answer: Be careful what you wish for.

By and large, today's big and small investors are as keenly focused on making a quick and easy buck as are the highly paid CEOs who have earned their scorn. They show little loyalty to the companies they buy, and for years they have been largely apathetic toward many of the governance reforms that might have prevented the Enron Corp. implosion or others like it. As one shareholder activist puts it: "Giv-

ing them a lot of power over how companies are run would be a disaster. Heaven help our private sector."

Why? For starters, the focus on quarterly numbers would become even more intense. "If institutional investors could make money by propping up results for the short term, that's what they would do," says Darrell K. Rigby of Bain & Co. "When that runs out, they'd just sell the stock and move on to something else."

Today, many shareholders have little more patience than the average Joe at a Vegas slot machine. Shareholder churn has reached unprecedented levels. In 1960, on average, only 12% of the shares of a New York Stock Exchange-listed company turned over annually. But by 1990, shareholder turnover jumped to 46%, then 88% in 2000, and 94% in 2001. Through May, the annualized rate hit 98%.

Yet ephemeral shareholders can sometimes be the most vociferous. "The vocal portion of our stockholder body has no long-term commitment to

the company," believes Henry B. Schacht, chairman of Lucent Technologies Inc. "They buy to sell. The quicker they can get a return on investment, the better."

Truth is, for all the grousing about CEO malfeasance, shareholders deserve a good deal of the blame themselves for the current corporate mess. Institutional investors, shareholder advocates, and corporate raiders who made "maximizing shareholder value" the prevailing principle of American business. Through the 1980s' and 1990s' runup in CEO pay, you hardly heard a peep from shareholders—as long as they got theirs. Institutional investors routinely rubber-stamped the massive stock option programs that heavily diluted their own holdings and led to skyrocketing CEO pay.

And that's when shareholders got bothered to vote. "Many institutional investors don't exercise their ownership rights at all," says Jamie Heard, chief executive of Institutional Shareholder Services, the proxy advisory firm. When big investors get involved, many inevitably vote management's way or focus on special issues that have little to do with corporate governance.

With less loyalty to the institution, its employees, and its products, investors are solely motivated by the stock price. "Institutional investors could just as easily turn a blind eye to accounting practices that might increase the stock price in the short term," says Beverly

Behan, a governance consultant with McDelta Consulting LLC.

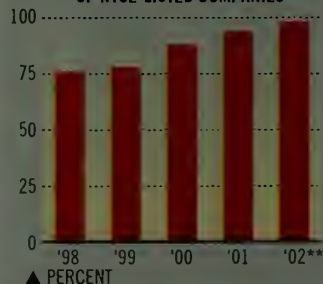
Corporate America has a long way to go to restore the checks and balances that would allow capital to work as effectively as it could. But as the debate rages over corporate governance reform, we should be mindful of the need for reason. Like directors, institutional investors

need only watch and question management, not micromanage the corporation.

Byrne covers management

SHAREHOLDER EXODUS

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In Business This Week

EDITED BY MONICA ROMAN

A PLAN TO BACKSTOP TERROR INSURANCE

FEAR OF TERRORISTS FINALLY overcame worries about trial lawyers as the Senate voted on June 18 to give insurers a federal backstop in the event of any future terror attacks. Under the Senate plan, approved 84-14, the Treasury would pay almost 80% of the first \$10 billion of damages, with the government's share rising to 90% in bigger catastrophes. That aid must be reconciled with a less-generous House-passed plan, which would give insurers low-cost loans to cover losses from terror attacks. The House and Senate may have an even harder time agreeing on lawsuit limits: The House bill shields businesses from terror liability, but Senate Democrats and Republicans deadlocked for weeks before approving much milder limits on suits. The White House favors tough limits but was

eager to get any bill from the Senate.

TACKLING CORPORATE REFORM

THERE'S NO SHORTAGE OF ideas on how to reform corporate governance, but now the Conference Board is getting into the act. The business research group has corralled a blue-ribbon panel to examine ethical practices and governance issues. Peter Peterson, chairman of the Blackstone Group, and John Snow, CSX's chairman, will spearhead the effort. The group includes such big names as Intel Chairman Andrew Grove, former SEC Chairman Arthur Levitt, and Vanguard Group founder John Bogle. The committee expects to complete best-practice guidelines by September.

NESTLE WANTS TO SCOOP UP DREYER'S

WHO'LL HAVE THE BIGGEST freezer in the ice-cream world? Swiss food giant Nestlé has proposed a \$2.6 billion deal to merge its ice-cream business with Dreyer's Grand Ice Cream, grouping Nestlé's Häagen-Dazs, Drumstick, and Nestlé Crunch brands with Dreyer's Edy's, Godiva, and Dreyer's ice-cream brands. The deal could increase Nestlé ice-cream sales to nearly \$2 billion, just ahead of its Dutch rival Unilever, which two years ago outbid Nestlé to acquire Ben & Jerry's. There's at least one sticky issue in the proposed deal, though: Dreyer's carries Ben & Jerry's ice cream on its delivery trucks. If the combination is approved by regulators, Nestlé would become a distributor of Unilever's product. Still, Nestlé executives say they don't plan to kick Ben & Jerry's off the truck.

HEADLINER: PETER DOLAN

BITTER PILLS AT BRISTOL

THE PRESSURE IS BUILDING on Bristol-Myers Squibb CEO Peter Dolan. A June 13 congressional hearing on ImClone Systems raised questions about whether Dolan rushed into signing a \$2 billion pact that awarded Bristol co-promotion rights to the biotech upstart's cancer drug Erbitux. The hearing revealed that some Bristol executives had doubts about the drug's regulatory prospects before the deal—concerns that proved valid after the Food & Drug Administration refused to accept the Erbitux application.



The ImClone investment isn't Dolan's only headache. Bristol's earnings are down due to generic competition and bloated wholesale inventories. And Bristol faces mounting lawsuits over efforts to delay generic rivals. Now, some investors are expressing frustration that Bristol's board hasn't moved to replace the 46-year-old Dolan. "He hasn't done anything right since he has been in charge," contends Jon Fisher, head of equity research at Fifth Third Bank. Dolan could not be reached for comment.

Amy B.

CLOSING BELL

iMAC FLAK

Apple Computer shares plunged 15%, to \$17.12, on June 19. Why? The computer maker warned third-quarter earnings would be as much as 10% below earlier forecasts as red-hot demand for its flat-panel iMac computer cooled. Investors pushed the company's stock to its lowest level since October.



PCs AREN'T SELLING, SO CHIPS ARE DOWN

ADVANCED MICRO DEVICES confirmed on June 18 that it's nail-biting time for the chip industry. The semiconductor company joined rival Intel in trimming forecasts for the second quarter, with both citing weakening consumer demand for PCs. AMD predicted sales may fall as much as 31% over the first quarter as seasonal PC purchases in May and June failed to materialize. With business spending on computers expected to remain stagnant in the second half of the year, the PC and semiconductor industry could have a hard time meeting expectations for a solid rebound.

NO ONE IS FIGHTING OVER XO NOW

AFTER LONG DEBATE, RESTON (Va.)-based XO Communications filed for Chapter 11 on

June 17. The broadband communications provider stated two alternatives. In XO's bank creditors voted to convert \$1 billion in long-term equity, secured debt, to new funding. In the alternative, Forstmann Little and Company, fonos de México would provide XO with \$800 million to pay off bondholders and continue operations. But Forstmann and Telmex want to buy XO because they say XO has met certain conditions. Now, Forstmann and Cahoon had been fighting for control of XO.

ET CETERA...

- TRW has struck a deal to sell its aeronautical unit to Goodrich for \$1.5 billion.
- Southwest Airlines has firmed a 1980 policy requiring large fliers to buy two tickets.
- Marc Andreessen has sold Loudcloud's Web-hosting business to EDS for \$63 million.

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PETROBRAS

EDITED BY RICHARD S. DUNHAM

THE ODD-COUPLE COALITION COMPLICATING BUSH'S MIDEAST POLICY

As the cycle of suicide bombings and military incursions inexorably pulled George W. Bush into the Middle East morass, his first instinct was to stand tall behind Israeli Prime Minister Ariel Sharon. Particularly in the aftermath of September 11, the President empathized with Israel's daily struggle against terrorism. That position also had a side benefit: It appealed to Christian conservatives and historically Democratic Jewish Americans, two important voting blocs.

But as the death toll mounts, Bush is under increasing pressure to recalibrate his policy to be more sympathetic to stateless Palestinians. And therein lies the conundrum. As he readies a blueprint for eventual Palestinian statehood, he faces a potential political backlash. For the Religious Right, a key component of the GOP base, the survival of Israel is a top issue. Christian conservatives see Israel as a democratic bastion of Judeo-Christian values in a virtually anti-American region.

At the same time, Bush's Mideast policies "are making inroads into the Jewish community," says Neil Goldstein of the American Jewish Congress. While Bush got just 19% of the Jewish vote in 2000, a small increase in that total could prove pivotal in swing states with sizable Jewish populations, including Florida, Michigan, and Pennsylvania. Early indications are that Bush has already won over many Jewish voters. His approval rating among New York Jews was 53% in April, up from 35% in June, according to the Quinnipiac University Poll.

The odd-couple alliance between Christian conservatives and pro-Israel Jews has solidified as Mideast violence has escalated—altering the political balance inside the Beltway. Despite their fundamental disagreements on social issues and church-state separation, leaders of the two movements

have jointly lobbied lawmakers in support of Israel. House Majority Whip Tom DeLay (R-Tex.), a staunch Sharon ally and critic of Palestinian Authority Chairman Yassir Arafat, pushed an uncompromising, pro-Israel resolution through the House with the assistance of liberal Representative and Holocaust survivor Tom Lantos (D-Calif.). Backing Israel is not just good foreign policy, says Gary Bauer, president of the conservative group American Values, "it's also good politics with Christians and American Jews who may be reevaluating traditional party loyalties."

But there's a catch: What might reap electoral benefits at home could imperil Bush's goals abroad. To realize one of his top priorities—ousting Iraq's Saddam Hussein—the President needs at least tacit support from moderate Arab states. Says Michael E. O'Hanlon, a Brookings Institution senior fellow: "We will need to show sensitivity to Palestinian concerns, particularly if we want to secure [military] base access." Tilting too far toward Israel could also undermine the war on terrorism. Many European allies, whose cooperation is crucial, are skeptical of Bush's pro-Sharon stance.

If there is no reduction in Mideast violence, any short-term domestic payoff could prove ephemeral for Bush. "Scoring points with the Christian Right and obtaining a better fund-raising position with American Jews now will do nothing for him if there is Armageddon in the Middle East in the early months of 2004," says Princeton University political scientist Fred I. Greenstein. That's why Bush is desperately seeking a middle ground. But it will be a neat trick to score points abroad without burning newly built bridges to Jewish voters at home.

By Alexandra Starr



HARD-LINE: Sharon, Religious Right's Bauer

CAPITAL WRAPUP

AL JOE, ALL THE TIME

Turn on the TV news, and there's Al Lieberman: probing corporate misconduct, pushing for a strong Homeland Security Dept., and challenging President Bush's environmental record. For months in the shadows, Senator Lieberman (D-Conn.) has finally found his voice and a compelling set of issues—and Democrats may have found a more effective spokesman than the aggressively partisan Senate Majority Leader Tom Daschle (D-S.D.). But just as Lieberman mounts his

national soapbox, it may be rudely kicked over. On June 28, former running mate Al Gore is set to convene a *loya jirga* in Memphis, a grand gathering of political and financial supporters meant to signal Gore's desire for a 2004 rematch with George W. Bush. Lieberman has said he won't seek the nomination if Gore goes for the gold.

So where does that leave Lieberman? Not totally out in the cold. The loyal second banana still tops the list of Gore running mates for '04.

Another scenario has Lieberman continuing with his high-profile legisla-

tive activities—and his heavy schedule of stumping for fellow Dems—in the guise of a noncandidate. If a Gore comeback fizzles, Lieberman would be ready to pick up the pieces.

Meantime, the Senate Governmental Affairs Committee chairman has no intention of leaving the national spotlight. In coming weeks, he'll call FBI Director Robert S. Mueller, CIA Director George J. Tenet, and Homeland Security Director Tom Ridge to testify before his panel. That will make headlines Al Gore could never grab.

By Lorraine Woellert

FINLAND

NOKIA'S NEXT ACT

Can the giant stay on top in an age of me-too phones?

The get-togethers were cordial and businesslike, the agenda ambitious. There were no raised voices, no objects hurled against the wall, and no sense of panic. But in a series of meetings starting last summer, the top five executives of Nokia Corp., the world's No. 1 maker of mobile phones, hammered out a strategy to remake the \$28 billion company's handset business from top to bottom. A decade after Nokia chucked its heritage as a maker of everything from toilet paper to rubber boots and bet its future on wireless communications, it was time for the next act.

The venue for the meetings was always the same. The managers convened for two hours at a stretch in an elegant, blond-wood-paneled conference room on the top floor of Nokia's soaring steel-and-glass headquarters overlooking the Gulf of Finland. Their immediate objective was to deal with the consequences of a dramatic slowdown in sales of wireless phones and equipment, both in the industry and at Nokia itself. Nokia's revenues had soared 54% in 2000 but hit a wall in the first half of 2001. This year the company will be

lucky if they notch up 5%, analysts say. The top brass also had to face up to resurgent competition from rivals left in the dust years earlier and the threat posed by Asian manufacturers. Then there was the challenge from software behemoth Microsoft Corp. Its push to get phone makers to adopt a version of its Windows software could erode Nokia's power.

Just before Christmas, the executives settled on a scheme that Nokia Chairman and CEO Jorma Ollila is convinced will propel his company to the next level. Few in the industry know the details of the changes, which Ollila was set to outline for analysts on June 20. But they are already in place: Effective May 1, Nokia split its monolithic \$21 billion mobile-phone unit into nine profit-and-loss centers, each charged with bolstering the company's position in a particular market, from \$1,000 smartphones for corporate customers to \$160 bare-bones handsets for users in developing countries. There's always a risk that such a massive overhaul could slow down the 53,000-person company. But Ollila, 51, argues it will have the opposite effect. "We foresaw that being too big was a real danger," he says. "We had to break up the company in a meaningful way to retain the entrepreneurial thrust we had in the 1990s."

It's the next stage in the maturation of the mobile industry. Nokia gets credit from analysts and rivals alike for having been the first to grasp that cell phones were becoming consumer items. In the mid-1990s, it started segmenting its prod-

uct line by "styles," such as Basic, Basic, and Fashion. But the mobile-phone division remained a single, increasingly unwieldy business unit. Now that structure is gone, replaced by a starry mini-Nokias. Heading them up is a generation of managers—six Scandinavians, two Brits, and an American.

Pretty dramatic stuff for a company that's still clearly on top. Despite the industry's woes, Nokia boasts enviable operating margins of 18% in hand and should see overall profits rise this year, to \$3.7 billion on sales of \$10 billion. Yet there also are signs that the company is losing its edge. It la-

NEO NOKIA

The Finnish company has reorganized its handset division into nine separate profit-and-loss centers.

TIME-DIVISION MULTIPLE ACCESS

Goal is to milk Nokia's 50%-plus share of a declining market. New investment will be minimal.

CODE-DIVISION MULTIPLE ACCESS

Will work to boost Nokia's paltry 9% market share in CDMA phones. The technology lies at the heart of all 3G systems.

MOBILE PHONES

Will focus on high-end GSM phones and their successors. Unit could generate more than half of total operating profits in future years.

MOBILE ENTERTAINMENT PRODUCTS

Will produce phones for developing countries. Will work with local mobile operators to offer consumer



OLLILA AT WORK

He hopes to keep Nokia vibrant by slicing it into units

them wirelessly—come from Japanese producers such as NEC Corp.

The new structure is designed to prevent such missteps. "We wanted to move faster, be more flexible," says Matti Alahuhta, 49, president of the mobile-phone business and the main architect of the reorganization.

The time was certainly right for radical measures. The mobile industry is in the midst of an historic transition driven by financial crisis and fast-changing technology. Cell-phone ownership is approaching saturation levels in the developed world. And the introduction of so-called third-generation wireless services is running behind schedule. What's more, financially strapped carriers are rolling back subsidies that made it possible for new cus-

tomers to take home \$200 phones for \$10. No wonder the industry lost money overall last year and should show only a modest profit in 2002, says Nomura International analyst Richard Windsor.

Figuring out what increasingly confused customers want is another challenge. Mobile phones used to be about talking—anytime, anywhere. Now they're becoming devices for sending and receiving data, as well. More than half of new phones come with built-in Web browsers, and a growing number include digital cameras or music players. Leaders in the PC business, including Microsoft and Intel Corp., have con-

cluded that this is their moment to barge in. "The trends are playing to our expertise," says Intel Vice-President Ron Smith, who is spearheading the chipmaker's bid to sell processors and other technology to phone makers.

There's yet another trend that could sap Nokia's luscious profit margins. Thanks to relentless improvements in chip design and manufacturing, it's possible to cram more and more features and power into silicon with each passing year. That feeds a steady commoditization of the basic building blocks of electronic products. In the past, only Nokia and a few others had the technical chops to design the special-purpose electronics that go into cell phones. Now, once-esoteric components are available off the shelf from multiple suppliers, and companies like Motorola, Texas Instruments, and France's Wavecom are hawking ready-to-assemble phone kits.

The upshot? It's easier than ever for low-cost producers to cobble together me-too phones and undercut Nokia. Retail prices for handsets have fallen from an average of \$275 five years ago to \$155. To stay on top, Nokia must differentiate its product through fancy software and hardware, such as the colorful graphic interface now featured on the 9200-series Communicator and the 7650 camera phone. Thus Nokia spends 60% of its \$2.7 billion research and development budget on software development, up from 30% five years ago.

All of these concerns weighed on Nokia's managers as they contemplated the future. "Our objective is to renew the whole industry in the next two years," says Alahuhta. That goal has already prompted unprecedented steps by Nokia to share its technology with other companies. Last fall, Nokia shocked attendees at the Comdex trade show by revealing plans to license its crown-jewel phone software to rivals. The move is meant to counter Microsoft's push into cell phones.

But nothing equals Nokia's internal reorganization for symbolic import. In place of a unified structure, Ollila & Co. have conjured up nine separate businesses, each with its own product R&D and marketing. One unit, for instance,

launch the anticipated camera phone, a color and snazzy software.

ENTERTAINMENT AND MEDIA

Its first order of business is marketing the 5510, a hybrid messaging phone and music player that hasn't caught on.

BUSINESS APPLICATIONS

Will pitch everything from smart phones to personal organizers at corporate customers.

MOBILE ENHANCEMENTS

Will hawk accessories ranging from cordless headsets to Star Wars-themed phone faceplates.

MOBILE SERVICES

Will run Club Nokia, an online clearinghouse for tech support information, downloadable ring tones, and Java applications.

Data: Company reports, Bear, Stearns & Co.

As the industry's leader, with 37% of the market, Nokia figured this period of crisis was the time to reassert its

will address the needs of business users. Another will focus on ultracheap phones for markets such as India and China. The very existence of such a group is a tacit admission that the old Nokia lacked the focus to win this segment. "Nokia became its own worst enemy," says Juha Christensen, the vice-president of Microsoft's mobility group. "By having vast economies of scale, it lost the ability to deal with niche markets."

The changes at Nokia parallel those that have occurred in other industries. By the 1920s, Henry Ford had figured out that not every customer wanted a black Model T. But his rival Alfred P. Sloan Jr. gained the upper hand by building a General Motors Corp. that housed separate divisions—Chevrolet, Oldsmobile, Cadillac—targeting different classes of buyers.

But GM had decades to perfect its system. Nokia has no such luxury. That's why Ollila's reorganization is fraught with risk. The sheer complexity of it might—instead of producing nimble, market-focused teams—simply gum up the works and confuse employees, clients, and investors.

To keep the separate units from straying too far apart, all will tap a 4,500-person central research lab for basic technology and product design. And to avoid diluting Nokia's efficiencies in procurement and manufacturing, each will hand off its products to a shared operations and logistics group. Still, there's ample room for overlap and turf battles. "These kinds of reorganizations look good on paper, but in practice they're difficult to implement," cautions John Jackson, an analyst at Boston-based telecom researcher The Yankee Group. While acknowledging the risk of conflicts, Ollila figures the kinks will be worked out as they arise. "We tried to respond to the realities of the marketplace, not to get mired in management philosophy and orthodoxy," he says.

There are plenty of tough realities to deal with. Take the challenges facing the new Mobile Entry Products division, led by Nokia's former Southeast Asia general manager, Bengt-Ake Gyllenberg. More than most senior executives at the company, he saw the ferment of Asian phones up close and understands the needs of customers in developing economies. Up to half of all phones sold today are already in the budget category. With his new unit, Gyl-

lenberg has the freedom to do what it takes to ensure that Nokia phones become the brand of choice for first-time buyers—even if that means taking such radical steps as buying technology from other suppliers or outsourcing more of its manufacturing.

The challenges are totally different at the Imaging Unit. Headed by veteran Juha Putkiranta, the division has to catch up quickly to the Japanese. When Nokia was developing its 7650 camera-phone, he says, managers came to realize they were dealing with an entirely different ecosystem than what they

were used to. "We were running big business with a basic set of standards," says Putkiranta. He had to line up component suppliers and create new ware for translating photos among mobile and Internet standards.

Nokia's rivals will be watching and experiment with a mix of curiosity and dread. If it works, the rush to imitate will be swift. If it doesn't—well, they will have to work even harder to catch on top. One way or another, they're going back to the Model T.

By Andy Reinhardt
Espoo, Finland

'HELLO, NOKIA, CHINA CALLING'



Chinese manufacturers seem to turn everything they touch into cheap commodities: toys, DVD players, and more. That's a boon to consumers, but a bane for multinationals that have lost a large chunk of their profits to low-cost Chinese rivals.

Now, it may be the turn of global mobile-phone giants, such as Nokia Corp., to feel the heat. Multinationals currently have a near lock on handset sales in China. But local manufacturers are expected to double their market share, to 30%, in the next two to three years. It may only be a matter of time before companies like

BEIJING CELLS
Chinese phone makers are rising fast

TCL Holdings Co. Ltd. and China Jian Co. begin churning out inexpensive cell phones for export. "China is going to become an integral force," says Larry Kung, director of strategic business development for Microsoft Greater China. Microsoft Corp. is working with Chinese handset makers using its Windows Smartphone software, which it's pushing as a standard operating system.

One of the companies allied with Microsoft is TCL of Guangdong. It's now the fourth-ranked seller of handsets in China, with more than 7% of the local market. San Diego-based Qualcomm Inc., meanwhile, is working with 18 Chinese manufacturers to produce phones using its code-division multiple access (CDMA) technology. "The Chinese will learn to make CDMA phones that they will sell around the world," says Qualcomm China President Richard Sulpizio.

China has nearly two dozen local handset makers—too many, says Peter A. Borger, president of Siemens Shanghai Mobile Communication Ltd. "There's most nobody below 30 million phones [of annual output] who is really profitable worldwide," says Borger. "China needs to consolidate its companies into two or three." However it plays out, those Chinese phones may be popping up in New York and London a lot sooner than Nokia would like.

By Bruce Einhorn in Shanghai



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RAS TANURA: What the Saudis need is investment, but so far they're blowing it.

ENERGY

DOES OPEC HAVE SAND IN ITS EYES?

Controlling output to keep prices high may be a big mistake

On June 25, OPEC oil ministers will converge on Vienna for one of the increasingly frequent gatherings known as "extraordinary meetings." They will most likely agree to retain their current production ceiling, which nominally holds about 5 million barrels per day off the market. For the past three years, the OPEC countries' main goal has been keeping prices near their target of \$25 per barrel. They have been successful: Crude trades at about \$26 per barrel.

But instead of congratulating themselves on getting top dollar, the leaders of the major Middle Eastern oil producers, including Saudi Arabia, Kuwait, and Iran, should be asking themselves whether their focus on price makes sense for the long haul. The gulf states may have almost 65% of the world's reserves, but at the end of the day, it's not what you have in the ground that matters: It's what you pump and sell. In that regard, the petrol kingdoms run the risk of having their share squeezed by increasingly bold non-OPEC rivals. "My great fear is that OPEC is getting more and more short-term," says Mehdi Varzi, president of Varzi Energy, a London investment firm.

While bringing in high revenues now, prices of \$25 or more will encourage greater investment in non-OPEC areas

as well as new technologies, such as alternative fuels, that could make OPEC oil obsolete. High prices also depress growth and, as a result, demand for oil—especially in oil-thirsty economies like India and China.

As an alternative, Leo Drollas, deputy director at the Center for Global Energy Studies, a London think tank, figures that adding one million barrels per day would help strengthen the shaky world recovery by gradually bringing prices down to the \$20 level. The gulf states would benefit, too: They need stronger economies to create jobs for the young, who otherwise are liable to recruitment by radical groups.

Yet to increase production, the Saudis and other big producers need outside help. International oil execs say the oil patch in countries such as Kuwait and Iran has been so isolated from the global industry that it is decades out of date. But oil in the Middle East remains so political that changing the way it is managed is difficult.

A case in point is Saudi Arabia's effort

to lure international oil companies to invest in gas and oil projects worth an estimated \$25 billion. You think that the Saudis desperately want jobs for their youthful population, but they roll out the red carpet for the contrary: Since Crown Prince Abdullah broached the idea in 1999, the Saudis have thrown up lots of obstacles. Exxon, Royal/Dutch Shell, and BP are said to be apart from the Saudis' issues: the quality of the

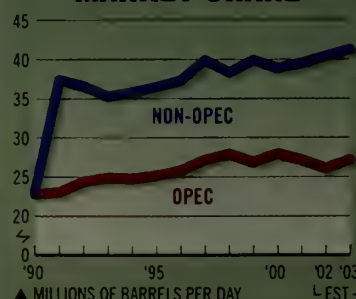
exploration acreage the kingdom is willing to let the companies explore, for example, and also the returns they may get on their investments. No surprise, then, that the biggest oil outfits are turning elsewhere. BP, ExxonMobil, and Shell are all pouring billions into non-OPEC zones such as the Caspian basin, the Gulf of Mexico, and Angola.

Thus, non-OPEC crude increasingly competes with OPEC's production. OPEC's share of the world oil market has fallen from 42% in 1999 and 2000 to 39% for this year, according to PFC Energy, a Washington consultant. Deutsche Bank forecasts that non-OPEC production through 2010 will grow at the rate of the 1990s. "The big Middle East producers may well have missed the boat by letting investment go to Russia and the Caspian," says Ed L. Morse, senior analyst at Hess Energy Trading Co. in New York.

Even some gulf officials are starting to doubt OPEC's strategy. "We were thinking that by 2010, our market share would get to 50%," says a senior gulf official. "That's going to be delayed if pressures increase, analysts think." Countries such as Saudi Arabia might be tempted to bring in outsiders to increase production and realize their true potential. There is little room for such rational thinking. But by proceeding in the short term, OPEC may sow the seeds of its own demise.

By Stanley Reed
London

OPEC IS LOSING MARKET SHARE



Data: Petroleum Finance Co.

COMMENTARY

By Brian Bremner

PRINTING YEN IS NOT THE ANSWER

Has the Bank of Japan blinked? Despite two years of withering political heat, BOJ Governor Haruhiko Hayami has resisted calls from inside the ruling Liberal Democratic Party to rev up the economy by opening up the monetary floodgates and printing yen like crazy. The BOJ would use much of the funds created to buy government bonds. That would foot the bill to keep the government's perpetual spending spree going—and dodge the need for fiscal discipline.

This sort of radical gambit—known as debt monetization in central-bank lingo—conjures up images of Germany's Weimar Republic. And Hayami has argued that short of some sort of catastrophe, it shouldn't be tried in Japan. In Japan's case, monetization wouldn't induce runaway inflation à la Weimar: Japan, in fact, is plagued by deflation. But it would zap what little reformist zeal Japan has left and could encourage policymakers to put off the tough measures—bank cleanups, corporate downsizing, debt workouts—that the country needs to get out of its 10-year funk.

What's more, monetizing the debt would keep an artificial lid on bond yields—now all at 1.3%, the lowest in the developed world—and thus long-term interest rates, since the market would see the BOJ as the buyer of last resort. To a purist like Hayami, higher rates would force the government to work harder to mend its ways. No surprise, then, that in a May 30 speech, Hayami hit the reform theme once again, warning that

"we should not be complacent."

Now, however, some argue that Hayami is bending to government pressure. Exhibit A: Japan's money supply is exploding. The country's monetary base, which includes cash in circulation and reserves held by Japanese commercial banks at the Bank of Japan, grew at an annualized pace of 29% in May and a sizzling 36% in April, vs. an average of 15.6% in the last quarter of 2001. For most developed countries, single-digit growth is the norm.

Which leads us to Exhibit B. The central bank isn't just providing liquidity for the banks, it has also developed a ravenous appetite for government bonds. Back in February, the BOJ announced that

it would increase its direct purchase of bonds from \$6.4 billion to \$8 billion a month.

At that rate, estimates Standard & Poor's sovereign credit analyst, Takahira Ogawa, up to 40% of the Japanese budget deficit in this fiscal year could be funded by the BOJ. That would be more than twice last year's level and certainly aids and abets the profligate politicians.

That surge in bond purchases has set the alarm bells ringing.

"Outright debt monetization has started," Merrill Lynch & Co. senior economist Jesper Koll recently wrote in *The Daily*

Yomiuri. S&P's Ogawa also thinks that the BOJ caved. With tax revenues falling and government debt now about 140% of gross domestic product—instead of between 40% and 60% as in most countries—strong-arming the central bank into funding the budget is the "last avenue to stabilize the government's debt trajectory," he figures.

The BOJ insists that all this talk is sheer nonsense. Sure, it has raised its daily targets for banking-system reserves five times since March of 2001 and created the cash for the system to meet these targets. On Feb. 28, it



pushed up its target from \$40 billion to as much as a staggering \$120 billion. But the BOJ swears it had good reasons. First, it says, it needed to calm jittery markets worried about the possibility of major bank failures at the end of the fiscal year in March, when a weak Nikkei stock average and mounting dud loans pounded the earnings and capital base of big Tokyo money-center lenders. Then, in April, a computer crash involving the ATM network of Japan's biggest bank, Mizuho, raised the specter of a run

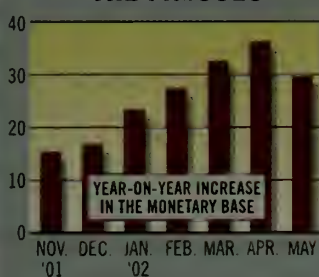
on deposits there and at other banks. The Bank of Japan was merely responding to the need to keep the cash spigot on, as the minutes of its Apr. 30 meeting, released on June 17, show. The central bank also says buying bonds is a tool that it needs to hit its daily reserve targets.

Maybe, but with the banking system stabilized again, deflation showing signs of easing, and annualized first-quarter growth reported at 5.7%, it is hard to justify such a radical ramp-up in bond purchases. Japan's economy is weak, but the Weimar Republic it isn't. Yes, ultraloose monetary policy will come in handy should Japan's economic reforms ever get off the ground—but only then. Perhaps it's time for Governor Hayami to reclaim his reformist credentials and bring the binge to a halt.

Bremner covers finance from Tokyo.



CRANKING UP THE PRESSES



▲ PERCENT Data: Bank of Japan

EDITED BY ROSE BRADY

BRAZIL: THE LEFTIST WHO'S SPOOKING THE MARKETS

It's just what Latin America doesn't need—an Argentine-style crisis of panicked markets and debt default that damages the region's economy and scares investors away. Yet that's the scenario analysts are beginning to worry could unfold in Brazil, a bigger economy where foreign banks and companies are more financially exposed than in Argentina.

At the center of the storm is Luiz Inácio "Lula" da Silva, leader of the left-wing Workers' Party. Lula, as he is known, is making his fourth run for President in the upcoming October election. Official campaigning starts in early July, and this time, Lula has his best chance ever at winning. He is more than 20 points ahead of his closest rival, free-market centrist José Serra, the candidate of President Fernando Henrique Cardoso's Brazilian Social Democratic Party, in public opinion polls.

Lula's ascendance is helping to rattle Brazil's markets. Indeed, investors are worried that Serra, whose campaign is off to a weak start, won't be able to close the gap with Lula, a 56-year-old former union leader who heroically resisted earlier military regimes but who declared in an earlier campaign that a burdened Brazil should not bother to pay its foreign debt. That memory, although distant, is spooking investors. The Brazilian currency, the real, has plunged 14% this year and on June 12 hit its second-lowest level against the dollar ever. That prompted the government to tap a \$9.4 billion International Monetary Fund credit line to bolster the real, strengthening it slightly.

At the same time, some investors fear Brazil may be unable to avoid a default on its \$260 billion in public debt—especially early next year, when the new government has to roll over a sizable chunk of it. At 54% of gross domestic product, the debt is nowhere that of Japan or other highly leveraged countries, and only \$93 billion is owed to foreigners. Still, analysts are worried that 90% of the domestic debt is in-

dexed to local interest rates, the dollar, or inflation—making it harder to pay if markets stay jittery.

It's not a formula for stability. "Following the default of Argentina, investors tend to sell first and ask questions later. That's what you are seeing in Brazil," says Jonathan B. Berman, senior investment officer at Standard Asset Management in Miami. A Lula win would lead to "economic chaos," he says.

The leftist candidate, a former metalworker, strongly rejects such a forecast. He pledges to honor Brazil's debt agreements

and maintain the fiscal discipline that marked Cardoso's eight years in power—a policy in which he tamed triple-digit inflation, brought free-spending municipal and state governments under control, and privatized \$70 billion in federal assets. Even so, investors remain skeptical because the Workers' Party platform, approved last December, lays out a radical vision. The platform calls for "a break with the current economic model" and steps to "superintend and reevaluate the privatization program."

Voters, including those in the business community, are waiting to see if the party includes details of such policies in its election manifesto due to be published on June 30. "Investors will analyze that the party is more radical than the party leadership, and they wonder who, if elected, Lula is going to pay attention to," says Christopher Garman, a political and economic analyst at São Paulo consulting firm Tendências.

As campaigning intensifies, business is expected to back Serra strongly, since his victory would mean a continuation of Cardoso economic policies. The 60-year-old Serra won poor reviews for his stint as Health Minister in Cardoso's government, but he lacks charisma on the campaign trail. He can't boost his appeal to voters fast, Brazil's financial markets—and the economy—may be in for a wild ride.

By Andrew Downie in Rio de Janeiro



DA SILVA: How radical?

GLOBAL WRAPUP

TOUGH FIGHT IN SOUTH KOREA

► The race to succeed Kim Dae Jung as President of South Korea has taken another dramatic turn. Just three months ago, Roh Moo Hyun, 55, was far ahead in the polls after Kim's Millennium Democratic Party chose him as its candidate. Roh, a human rights lawyer, was seen as a fresh face by voters. But now, Lee Hoi Chang, the 66-year-old candidate of the Grand National Party, has made a comeback.

His party is set to take control of most major cities and provinces on

July 1 after a landslide victory in June 13 local elections, winning 11 of 16 key mayorships and governorships. That election is seen as a barometer for the December presidential ballot. Polls held since the local elections show Lee leading Roh by as much as 15 points.

Lee's conservative opposition party won big in the local elections after attacking recent corruption scandals involving Kim's sons, his aides, and appointees. Analysts say voters are disappointed at Kim's failure to clean up the graft-tainted political system, even though he rescued the country

from bankruptcy in the 1997-1998 Asian crisis. Roh also hurt his image when he sought help from Kim You Sam, part of the Old Guard of Korean politics. "Unless Lee makes a catastrophic blunder or the ruling party pulls off a dramatic surprise, Lee appears set to walk into the [presidential] Blue House," says Shin Jung Hyun, a political science professor at Seoul's Kyunghee University. The next test of the candidates comes in August by-elections, when a dozen parliamentary seats will be at stake.

By Moon Ihlwan in Seoul

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no boundaries

MESSIER ON THE RECORD: SETTLING INTO THE HOT SEAT

The Vivendi Universal CEO talks about his precarious position—and his plans for getting the job done

It's hard to open a newspaper these days without seeing something about Jean-Marie Messier, CEO of Vivendi Universal. Vivendi started out as a water utility but is now a \$50-billion-a-year media conglomerate after its purchase in 2000 of Seagram and its Universal movie and music businesses.

Today, Vivendi is wrestling with big challenges. It lost money last year after taking a big writedown. It has huge debt, and it has seen its share price drop some 79% from its peak in March, 2000. And, as with AOL Time Warner, the very idea of a media conglomerate with lucrative synergies among its units is open to question in the minds of some. That has stirred speculation that Messier may not survive as CEO.

BusinessWeek Editor-in-Chief Stephen B. Shepard spoke to Messier about these issues on June 13, as part of the magazine's Captains of Industry series at Manhattan's 92nd Street Y. Here are some excerpts from that conversation:

Last December, you said the French cultural exception was dead. Tell us what you meant by the remark and why it caused such a stir in France.

Our world is becoming [one] of cultural diversity, and speaking of national culture is not that meaningful. You have to realize that [I spoke] in the context of the French election [in which nationalism was an issue]. I do regret that I caused such emotion. But if to any extent my statement has been part of the fight against [unsuccessful right-wing French presidential candidate] Mr. [Jean-Marie] Le Pen and his ideas, I am proud of that. As a Frenchman, when I see people like Le Pen and the risk that they represent for our country and for all culture, I have only one thing to say: "Mr. Le Pen, no. No where, never."



**MESSIER
SAYS HIS
BOARD
STANDS
BEHIND HIM**

What language is spoken within Vivendi in France?

All our board meetings and executive committee meetings are in English, with all the documents in English. The rule is that if someone wants to speak French, he can.

You created Vivendi Universal to marry content and distribution and take advantage of emerging broadband technology. Why does a content company have to own distribution? Why not let the markets sort out the relationship between content providers and producers?

Vivendi Universal is 75% content and one-fourth distribution. So, we are first a content company. We do not intend to be more than regional distribution players. But in some fields, distributors become so strong that they can squeeze the margins of the content provider. You gain leverage in making alliances with other distributors.

Why has the promise of broadband gone unfulfilled?

Those technologies are very late. We were expecting that they would come in one year, then we realized that it wouldn't come for two or three additional years. Did we invest too much two years ago in the new technology? Yes. And we have to reduce our investment. But would it be wise to reduce those investments? No. Because the trend of broadband is there.

A lot of users want to download music and burn CDs and share them with friends. The technology companies do seem to think it's their responsibility to prevent that. Yet content providers have intellectual property rights to protect. How do we deal with this?

You will never be successful if you don't give the customer what he is looking for. We were unable to give the right service and the right added value.

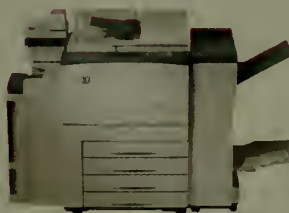
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to the customer. So, first to be blamed are the content and music companies. That's the reason why, in the movie industry, for example, we are trying to be first online to offer new services.

How can we solve the problem? First, giving the right answer to the consumer. Second, agreements with manufacturers and software companies. We were the first content company to make an alliance with one manufacturer—Thomson Multimedia—to defend intellectual property rights. [But] there is a cost. At the end of the day, we will have to discuss money [with consumers]. And third, education. Let's explain to our children that stealing music or movies is just trading the value of creativity for zero.



“Did we invest too much two years ago in the new technologies? Yes.... But would it be wise to stop those investments? No.”

— JEAN-MARIE MESSIER, Vivendi Universal

Vivendi has to reduce debt. How are you doing that? What is the situation with Vivendi Environnement, the water unit?

First, in the past we made some errors by pre-announcing what we were going to do. So I'm not going to [do that] again. [On June 17, Vivendi's board okayed plans to reduce the stake in Vivendi Environnement from 63% to just over 40% when market conditions are “appropriate.”]

One recent rumor was that Vivendi had to dip into a reserve fund to the tune of \$1 billion to pay dividends and some related taxes. Is that true?

When you manage a company, you are not like a retail store. You do not keep the cash. You put it into bank accounts and have undrawn facilities. Those banks tell me: “I will give you up to X-billion dollars, and when you need them, just call.” This was the case for our dividend. Banks are ready to give us more than 3.2 billion euros.

So there is no cash-flow problem?

Our media assets will generate this year close to 2 billion euros in operating cash flow. Month by month, our excess liquidity is 4 billion to 6 billion euros. That means that if there were a new macroeconomic event like September 11, in the worst-case scenario, Vivendi is not at risk.

You own only 44% of telecom outfit

Cegetel, and under U.S. accounting rules, you can't consolidate earnings unless you have at least 50%. But you consolidate all Cegetel earnings.

That's not our choice. Under U.S. generally accepted accounting principles, as under French GAAP, we are obligated to consolidate. When we introduced Vivendi Universal into the New York Stock Exchange, the [Securities & Exchange Commission] reviewed and [ruled that we] consolidate. We have to state, especially in terms of debt, both consolidated earnings and proportionate earnings.

How would you describe your relationship with Barry Diller?

Barry Diller manages all of VU's TV and film operations in the U.S.... integrating those activities, [finding] the efficiencies. Barry Diller is someone who, since he left Rupert Murdoch, has never accepted working for anyone. Why would he work for this little French guy? Barry has a great ego, true. But he has something greater than his ego, that's his talent. And I prefer to have Barry Diller working with Vivendi Universal than with someone else. We have no contract between us. That's the reason it's going to last for a long time, because we have a strong mutual interest in working together.

What has he done so far? Is there new programming?

We have three key new channels to launch around yearend or at the beginning of next year. When you have Universal Music within your group, you have the right tool to create a competitor for MTV, which went from being a provocative channel 21 years ago to more a way-of-life channel now.

So there is an opportunity for Vivendi to compete with MTV?

When you look to the music TV market, yes, there is room for competition.

And Barry would help you do it?

Barry, along with the strength of the Universal Music team.

There are rumors that you are going to lose your job. Do you think it would happen?

I am not the owner of my company. I am a paid CEO. So from the first day I became a CEO, I knew that this job would stop tomorrow morning if my board of directors lose their confidence in me and decide to change the CEO. That's the way I do hope to be able to continue to work for you, let's say, for the next 15 years.

It's fair to say that at least one of the directors of Vivendi Universal has expressed—in a manner that I'm not sure is in the best interest of all shareholders—his dissatisfaction with our price and the way the company is managed. Okay. You have to live with it.

day I have a strong support from the board. I have to execute a merger. We have the best margins in our industries and are in the top of performance. That's the way I'm going to continue to work for you.

value for this company and its shareholders. I'm not thinking every morning about whether I will lose my job.

But the Board did establish a committee to oversee you?

Not to oversee. This is part of a misperception in the media. We announced the creation of a corporate governance committee which, for me, is of the basics. The creation of this corporate governance committee became the news of the day. And the following day in the media, it was “Messier under scrutiny. There is a committee created to oversee what he is doing every day. Stop. I am in charge of the day-to-day job. If the board is not satisfied with my job, it has to oust me, not to oversee these day-to-day actions.”

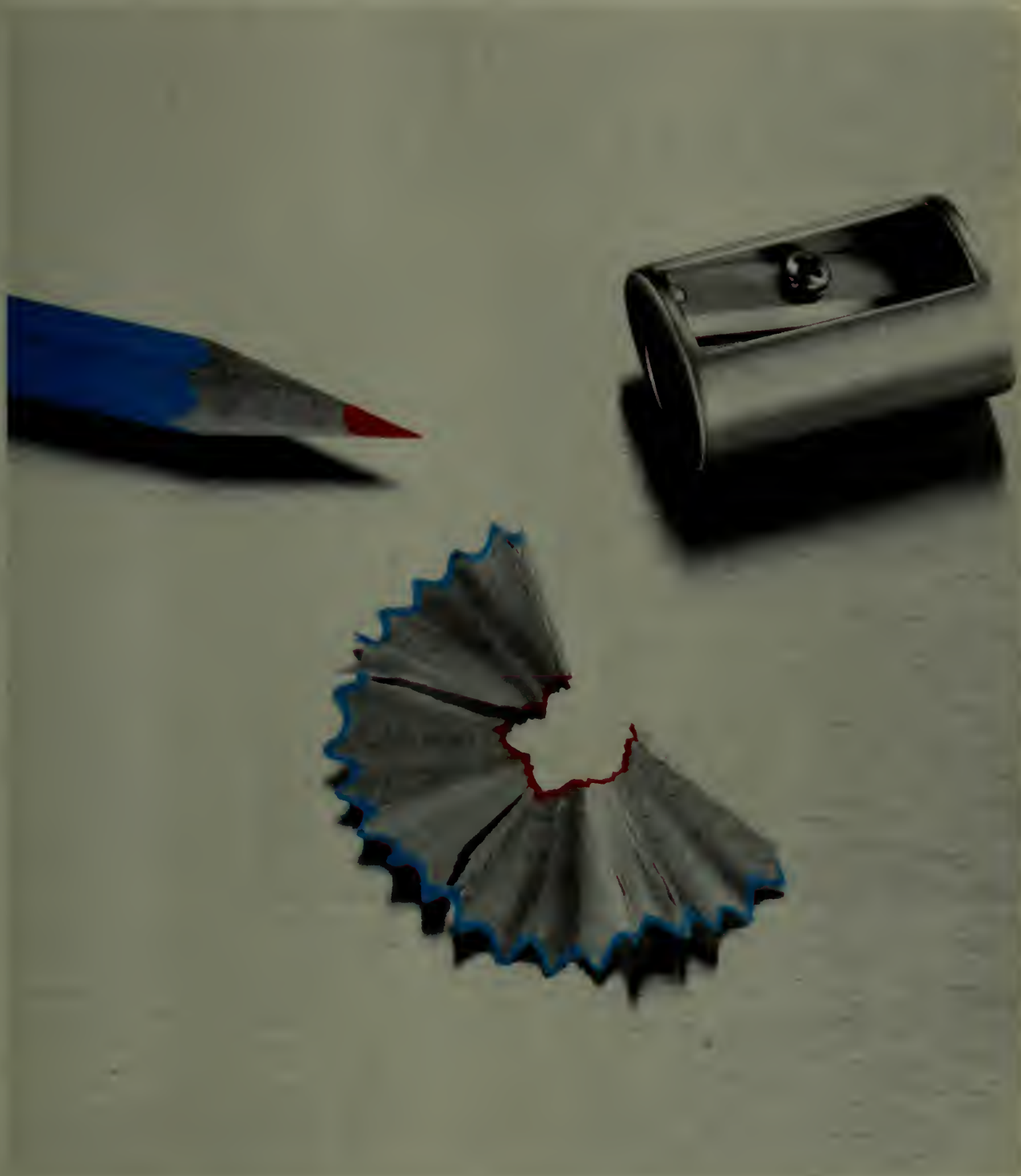
Do you have any regrets about your performance?

As CEO, I have made errors. And one of them has been to take too high a media profile on a personal basis. We had to correct that. On the other hand, the media, and the markets, are in many cases overreacting. One of the most difficult tasks I have today is how I can get Vivendi Universal out of the headlines.

BusinessWeek online

For a complete video of the interview, go to the July 1 issue online at www.businessweek.com.

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GENERAL MALAISE AT GENERAL MILLS

Rivals have been eating its lunch since the Pillsbury deal



**SANGER:
UNDER
PRESSURE
TO DELIVER**

It was to be Stephen W. Sanger's crowning achievement. Last November, after a 16-month delay, General Mills's chief executive closed on the biggest takeover in the company's 136-year history: its \$10.4 billion purchase of long-term crosstown rival Pillsbury from Diageo PLC. Within months, Sanger promised, the combined company—with sales of \$13.5 billion—would produce stellar returns as it bulked up and broke into new fast-growing food categories to supplement its stodgy cereal busi-

ness, with its familiar Cheerios, Chex, and Wheaties brands.

Unfortunately, the postmerger reality hasn't come close to reflecting Sanger's initial optimism. During the year and a half it took to complete the merger and integration of Pillsbury, competitors have made serious inroads in areas Minneapolis-based General Mills once dominated. Profits in its third quarter, ended Feb. 24 slid 48%, to \$82.5 million. In the fourth quarter, which ended on May 26, Prudential Securities Inc. analyst John

McMillin predicts a 25% decline from year ago; he expects an 8.7% drop in full-year earnings from continuing operations, down from last year's \$636.3 million. (The company unveils its annual numbers on June 26.) And the merger boosted General Mills's debt load to \$9.9 billion from \$3.7 billion. In April, its A- credit rating was cut to BBB+ by Standard & Poor's, which noted the softer earnings. "It's obvious that the focus on integration has taken a toll on our sales growth and our earnings growth," Sanger says.

Investors are paying the price. Since January, the stock price, recently \$43.60, has sunk 14%, while the Standard & Poor's Food Products Index has risen 1%. Sanger's record will likely earn him some time to fix things. His expertise in marketing, after all, helped General Mills achieve consistent double-digit earnings gains before the merger. For instance, he turned Yoplait yogurt into the segment leader. But now Sanger is under pressure to deliver. Any reserve of goodwill benefiting Sanger, who has been CEO for seven years, is likely to dry up if he doesn't produce strong numbers by the fall and winter—prime selling season for Pillsbury's soup and baked goods. "There is a potential for more there," says Kevin McCloskey, a portfolio manager at Federated Investors, who has 600,000 General Mills shares. "There's a lot of uncertainty."

The problems started when Sanger badly underestimated how long it would take to resolve antitrust issues arising from the merger, announced in July, 2000. Ultimately, to satisfy regulators, Pillsbury had to sell its desserts and specialty-products businesses to International Multifoods Corp. Moreover, Pillsbury parent Diageo cut back its marketing efforts in anticipation of the division's new ownership. That resulted in lower sales for such core brands as Pillsbury refrigerated biscuits and Progresso soups. By the time the merger was final, General Mills rivals had eaten into its key markets.

The most embarrassing loss to General Mills was its slide to second place in the past year in the \$7 billion cereal category, which it had led since 1999. Tak-

advantage of the turmoil, General Mills and Kellogg (K)

LESS DOUG
Some brand suffer as the merger stalls

SHELF FULL OF PROBLEMS

A bit of indigestion at General Mills?

HUNGRY COMPETITORS After the Pillsbury merger was announced, rivals attacked in some key markets. Most notably, Kellogg became the industry leader in breakfast cereal for the first time since 1999.

FAMISHED FOR NEW PRODUCTS New products and innovative extensions shrank in the merger's aftermath. Typically, General Mills launches close to 25 new products in each quarter. In the fourth quarter there were only two.

STARVED FOR PROMOTIONS Pillsbury reduced its marketing budget before the merger closed, and sales of such brands as Progresso soups and Pillsbury biscuits declined.



Australia shifted Honda's incentive program into top gear.

and it's not surprising. Nowhere else has Australia's unique combination of world-class facilities, great value, entrancing locations and superb weather. Add Australia's world-famous friendliness and Honda Brazil's decision to hold their incentive

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The Corporation

launched a slew of products, including a line of Disney-theme cereals, such as Mickey's Magix. It also heavily promoted adult brands with high-growth potential, such as Special K and Smart Start. In the first quarter, those lines saw sales rise by 18% and 70%, respectively. "We've focused on fewer, bigger brands," says Kellogg CEO Carlos M. Gutierrez. Kellogg now has 33% of the cereal market vs. 32% for General Mills—an exact flop from a year ago. "The war continues," says Gutierrez. "We've just won a couple of battles."

Other rivals have also smelled blood in refrigerated dough, where Pillsbury has long led the pack, deep-pocketed Sara Lee, with the purchase of Eagle Brand grains, is gunning for more market share. Nestlé is introducing a line of refrigerated cookie dough. And in both prepared meals—a category General Mills invented with Hamburger Helper—ConAgra, Lipton, Kraft Foods, and Campbell Soup have all trotted out new products. Even Sanger concedes that ConAgra's Homestyle Bakes, which contain meat, are good. Says Eric M. Sanger, a consumer-products analyst with Federated Investors: "General Mills is out-innovated by these other guys."

Sanger slashed new products and motions to concentrate on integrating and strengthening the two companies' sales and marketing forces. Many Pillsbury salespeople had left, unsure whether they would have jobs, and tailors were unhappy about the lack of support Pillsbury goods were getting. "When you ask a General Mills salesperson about a Pillsbury product, they eyes glaze over," says Rick Bozzell, promotional manager at grocer Super Valu Inc. Promotional dollars for Pillsbury had vanished, he says. Faced with either focusing on new products or straightening out its marketing machine, Sanger chose the latter. By the fourth quarter, there were only two product launches, vs. the usual two dozen.

Now, General Mills is playing catch-up. It plans to roll out 80 new products in the six months following June. Some are brand extensions, like Bananas & Nut Morning Chex Mix. Others are new, like Yoplait Nouriche, a liquid replacement. Moreover, the company says it will use an additional \$100 million in cost savings from the merger to promote these new products as well as the declining Pillsbury lines.

It's a sound plan. But if Sanger fails to follow through, the man who sells Breakfast of Champions could soon find himself eating crow instead.

By Julie Forster in Minneapolis

Hard news. Human touch.



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THE HEALTHY TRAVELER



Managing Your Health When You're Away

Staying healthy is the key to staying productive on the road. But stress, disrupted sleep, calorie-laden expense-account meals, arid aircraft cabins, and long, intense workdays all eventually take their toll.

Fortunately, there are plenty of places to turn for help...from airline amenity kits with soothing balms, mists and emollients, to hotels with blackout curtains and soundproofing, to providers of "distance medicine" services to international travelers.

This special section will cover the many important ways of protecting and managing your health when you're away from home.

PREVENTIVE TECHNIQUES

Plenty of frequent travelers stay healthy and productive on the road. What's their secret? Here are some road warrior tips, both preventive and palliative:

- Keep hydrated.** Drinking lots of fluids when you fly is essential to good health; the symptoms of dehydration can include everything from headache and lightheadedness to nausea. Be sure by advising drinking 8-12 ounces of nonalcoholic, caffeine-free fluid for every hour you're aloft, experts suggest. Use petroleum jelly or mineral oil to coat the inside of your nostrils to keep your lips moist with lip balm, to suck on lozenges or chew gum to keep your mouth wet, and to be liberal with saline nasal spray. "Bacteria essentially slide off wetness," says Dr. Herbert Patrick, a respiratory specialist at Thomas Jefferson University Hospital in Philadelphia. Many travelers swear by personal air purifiers, the kind worn around the neck. Others never leave home without antibacterial hand lotion.

- Exercise in moderation.** Besides helping you stay in shape, exercise will help you manage jet lag (see below), and trigger the "relaxation response" that counteracts the physiological consequences of stress. It's a good idea to get some form of exercise on the plane – either by walking around, doing simple stretches in your seat, or even trying yoga. JetBlue Airways now supplies passengers with a yoga instruction card, describing four poses passengers can perform while in their seats. Or pick up *In Flight Yoga*, an audiocassette marketed by a TV producer turned yoga teacher, Carol Dickman, at www.stretch.com.



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Rx

ON THE GROUND

Several hotel companies have made significant investments in health club facilities in their city and airport properties to make it easier for guests far from home and their fitness routines, to fit in a workout. At Hilton, the health clubs at Boston/Logan, Atlanta, Miami, New Orleans, O'Hare and LAX all have substantial facilities. "The health clubs at airport hotels are doing gangbusters," said Jeanne Datz, a spokesperson for **Hilton Hotels Corporation**. "Transit passengers can pay a modest day rate and take advantage of the pool – some properties even have lap pools – plus weight rooms and saunas." At O'Hare, the Hilton is actually in the terminal; at others it's just a matter of jumping on a complimentary airport shuttle.

At **Renaissance Hotels**, many of the properties have fitness centers that rival the kind found at resorts. In Toronto, where the Renaissance hotel is connected to the Skydome, the health club facilities include five squash courts and nine holes of golf. In Walnut Creek, California, in the heart of Silicon Valley, the new Renaissance has a "concept" health club called Renaissance Club Sport, with a 12,500 square foot fitness center, an aquatics center, an NCAA regulation basketball court, racquetball, handball and squash courts; plus classes in step, cycling, yoga, Pilates, tai chi, kickboxing, aerobics, stretching, and strengthening. There's also a full menu of health and wellness services provided, including testing, personal training, nutrition counseling, cardiac rehab, sport-specific training, etc.

Eat properly and get enough sleep.

A survey of 1,000 business travelers sponsored by Hilton found that travelers tend to eat more than usual on business trips, and many road warriors drink more alcohol than they do at home – habits that interfere with getting a good night's sleep.

"Convenience usually comes before health when you're running yourself ragged on a business trip," said Pam Smith, registered dietician, noted nutritionist, and author of "The Energy Edge," and a consultant for Hyatt Hotels' heart-healthy Cuisine Naturelle program. "The goal was to provide great-tasting dishes that the frequent traveler can indulge in, while being kind to their bodies."

Hilton has a similar program of low-fat meals on its menus, as do

strains of hepatitis. US Assist, a global medical and legal assistance service provider, has the following recommendations for international business travelers:

Before you go:

- Have all necessary vaccinations
- Take all recommended medication
- Get the name and address of an English-speaking physician at your destination.
- Take a medical kit containing a variety of over-the-counter preparations for headache, queasy stomach, sunburn, etc.
- Pack an extra pair of prescription glasses or contact lenses.
- Bring a copy of the prescription for any medication you're taking. You may need a refill, or, since dr

Take a medical kit containing a variety of over-the-counter preparations for headache, queasy stomach, sunburn, etc.

Four Seasons and Sheraton. But when a healthy meal is simply not available, or you're rushing out of your hotel room, eating a balanced meal may be impossible. For those times, nutritionist Smith offers the following suggestions:

- ❖ Pack healthy, easy-to-grab snacks – low-fat breakfast bars, whole-grain crackers, fruit and sunflower seeds.
- ❖ Instant oatmeal is a quick, healthy, hearty breakfast (or snack) choice that can be prepared easily in your hotel room.
- ❖ Order what you like, and only eat half.

Be especially vigilant when traveling to a foreign country. It's wise to be concerned about contaminated water and food. In some places, you must also worry about malaria, and deadly

names differ from country to country. It's a way for a doctor to know exactly what you're taking.

While abroad:

- Avoid tap water, ice cubes and fruits and vegetables.
- Don't rely solely on embassies for emergency assistance. Not all are prepared to help you in a crisis.
- Hire a cab or driver. Road accidents are the leading cause of death for travelers.





DEALING WITH JET LAG

an irritating fact of life for travelers: the quid pro quo for the ability to dash across multiple time zones faster than your body clock can reset itself. Most travelers, as many as 90 percent, suffer from the lag syndrome – some acutely. Symptoms can include intense fatigue, headaches, irritability, digestive problems, insomnia, sleepiness, dizziness and a foggy head. While none of these are terribly threatening, many can make the first few days of a business trip a misery. Research suggests that cognitive function may be impaired by jet lag, which is why many companies advise their traveling executives to wait a day before planning high-level meetings. Sadly, there's no real cure, but there are plenty of ways to speed up your body's ability to "phase adjust" to a new time zone:

Take nonstop flights whenever possible. You'll spend less time in the air, and have more time to adjust once you are there.

Adjust as soon as you board the plane, to your watch to the time zone at your destination. Then, whenever possible, do on board what you would do if you were at your destination. If it's dinnertime, have a light meal. If it's bedtime, try to take a nap. Bring whatever you need to help you sleep on board: eyeshades, earplugs, travel pillows, neck rests.

Stay away from alcohol. Besides its diuretic effect, it also disrupts your natural sleep rhythms.

Adjust as soon as you can, get out in the sun. Natural light stimulates the pineal gland, which helps regulate your circadian rhythms.

Get some exercise. A light workout

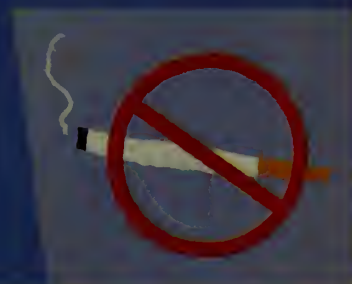
will make you feel better and may help you readjust faster.

- **Limit a daytime nap to no more than three hours.**
- **Take it easy when you first arrive.** Researchers say it takes your body one day per time zone crossed to adjust. If you're flying to Australia, it can take more than a week to adjust.
- **Don't believe the hype about quick cures.** The "Jet Lag Diet" has been thoroughly debunked by sleep researchers. A controlled study by the U.S. Army actually found that the practitioners had a harder time adjusting than the non-dieters.
- **Be wary of over-the-counter medications.** Some people think Melatonin is great, but it isn't FDA approved, and safety and efficacy studies haven't been completed. Researchers are still determining proper dosages – how much to take at what time of the day, in all age groups by both sexes.

Dealing With Illness Away from Home

Even mild colds can make flying a nightmare, but if you fall seriously ill far away from home, the health risk may increase considerably. Sound dire? Actually, help is easy to find. Here are some useful resources:

- **The Centers for Disease Control and Prevention Web site** (www.cdc.gov/travel) provides up-to-date information about disease outbreaks and vaccine requirements for specific countries and regions.
- **International Society of Travel Medicine** (www.istm.org) lists information about necessary vaccinations and offers referrals to travel health specialists and travel health clinics around the world.
- **Travel Health Online** (www.tripprep.com) offers a well-organized collection of sections on travel-related health concerns, from deep vein thrombosis to altitude sickness. There is especially interesting information for travelers with heart disease, diabetes and pulmonary problems.
- **Passport Health** (www.passporthealthusa.com) provides immunizations, health products, and information for international travelers. The company operates 31 U.S. franchises where travel health doctors and nurses receive clients and assess their travel health needs.



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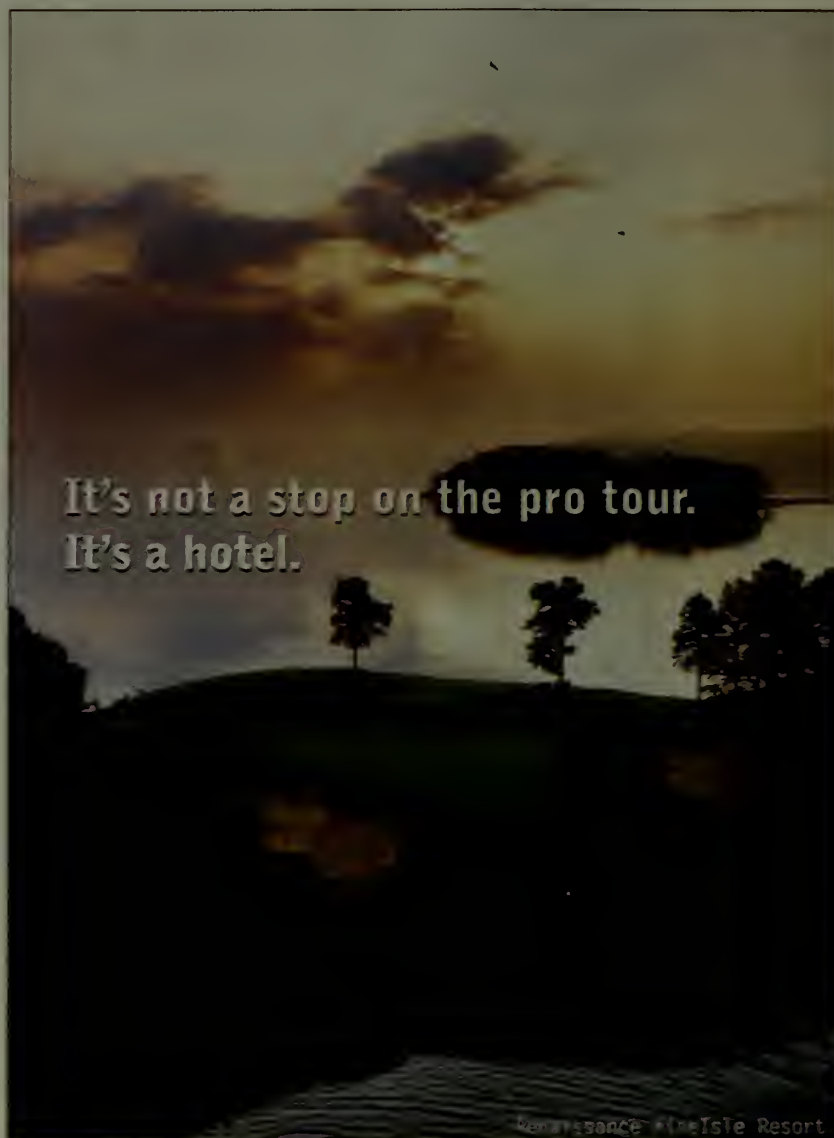
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BASKETBALL

RED STAR OVER HOUSTON?

The Rockets' No. 1 NBA draft pick may be Chinese

Even Shaquille O'Neal will have to look up to the probable first pick in this month's NBA draft. China's Yao Ming, 21, stands a shade over 7 foot 5 inches. And that's when he isn't wearing size 19 sneakers.

Among basketball insiders, there's little doubt that the Chinese giant's got it. "He'll be a good player," says NBA basketball analyst and former NBA coach Jack Ramsay. "He can handle the ball, run, and jump." To say nothing of Yao's knack for scoring. Playing for the Shanghai Sharks last season, the slender (236 pounds) big man averaged 41 points per game.

If there's a lingering question about Yao, it's whether the Chinese government will allow him to suit up. The Houston Rockets, who control the first pick in the June 26 draft, have spent weeks trying to coax a deal out of various Chinese sports federations and government officials. A team delegation, including coach Rudy Tomjanovich, returned home from a visit to Beijing on May 13. That came after Houston Mayor Lee P. Brown, on a trade mission to China, made a personal pitch for Yao. To be sure, selling Yao to the pros is tricky for the Chinese. A serious injury to the superstar could sideline him from the national basketball team, China's athletic pride and joy. Then there's the specter of defection.

Neither of the two Chinese who have played in the NBA has abandoned the mainland for the bright lights of their adopted NBA cities. But earlier this month, Wang Zhizhi, who played last season with the Dallas Mavericks, failed to report to China for mandatory training with the national team. (Wang's agent squelched defection speculation, saying the *Dallas Morning News* Wang intends to rejoin the national team.) Still, China and basketball watchers are much to recommend in a Yao-NBA marriage. Already, buzz surrounding the draft has enhanced the credibility of Chinese basketball around the world, and especially in the U.S. "It's a kind of self-validation—a way for the Chinese to say, 'We are pro-

ducing the best basketball player in the world this year,'" says David Bachman, chair of the University of Washington's China Studies Program.

Then there's the boost in Yao's on-court skills that is almost certain to occur after a few seasons trading baskets with O'Neal and other NBA behemoths. "Assuming [Chinese officials] have an interest in the growth of Chinese basketball, this is a huge benefit."

YAO: At 7 foot 5, he'll have Shaq looking up



WHAT CHINA WOULD GET

- ✓ Beijing would take about 50% of Yao's earnings, including endorsement deals
- ✓ Yao could play in national and international events during the summer
- ✓ Coaching expertise for the Shanghai Sharks, possibly Rockets exhibition games, and help in attracting non-Chinese players to play hoops in China
- ✓ \$350,000—the NBA limit for acquiring foreign players

The only way for players to get better is to play against the best," says Russ Granik, the NBA's deputy commissioner.

Millions of dollars may also salve concerns about Yao's playing in the U.S. About half of his earnings—roughly \$10.4 million over three years—would go to various sports and government agencies. And that doesn't count endorsement deals. "There's an interest there in striking a deal. But certainly, the Chinese side will do what it can to maximize value," says Bachman.

There are plenty of dollars at stake for the NBA, too. Chinese fans can already follow the draft on an NBA site presented in Mandarin Chinese. And

TV audiences there are growing. Six NBA games are telecast each week, and audiences climb when local heroes are on the court. For Wang's debut with the Mavericks in 2001, 300 million Chinese tuned in, according to the NBA.

A hotshot like Yao will only stoke interest further, predict NBA executives. The league is opening an office in China this year. By next season, it will have a licensed apparel deal that for the first time will allow fashion-conscious NBA fans in Beijing to shop for Jordan—and possibly Yao—jerseys at their corner clothing store.

By that time, Rockets officials say, Yao Mania may have taken root just as strongly in Houston. Among the city's 150,000 residents of Chinese descent, interest in the team has blossomed since the May 19 draft lottery in which the Rockets won the top spot. The next day, "we had a call from a prominent businessman of Chinese descent asking the price of 500 season tickets. That's unusual," says Rockets Chief Operating Officer George Postolos. Good prospect. But it will take Yao in a Rockets uniform to close the sale.

By Mark Hyman

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Developments to Watch

EDITED BY ADAM ASTON

KEY CLUE THAT MIGHT PUT THE BRAKES ON HIV

ALTHOUGH IT HAS LONG BEEN possible to detect the presence of HIV, the virus that causes AIDS, scientists have struggled to distinguish infected cells from healthy ones. Researchers at the University of Colorado now say they have explained the presence of what may be an important characteristic: When a cell produces HIV, a protein called CTLA4 appears on its surface.

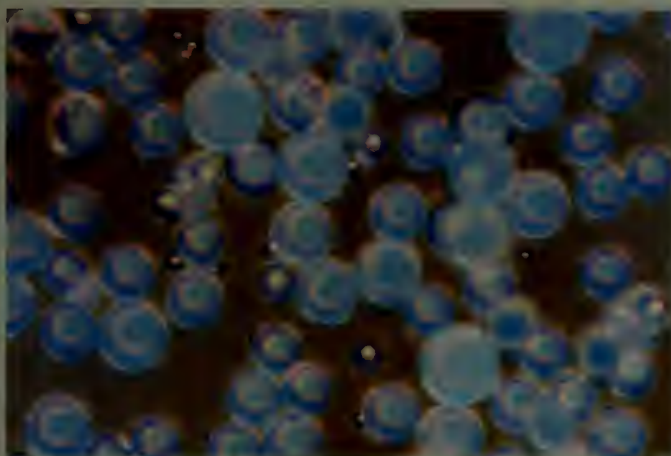
Researchers first observed CTLA4 on HIV-infected cells in the late 1990s, but no one could figure out how the protein related to the virus' replication process. Such cells tend to hoard copies of the virus inside instead of releasing them steadily after infection. This study shows that CTLA4 only migrates to the cell's outer surface when the infected virus is ready to be released.

The discovery "opens up new doors for figuring out new ways to stop cells from making new virus," says Arlene Franzusoff, an associate professor of cellular and molecular biology at the university's Health Sciences Center. The protein marker could also help doctors fine-tune the treatment of their patients' anti-HIV drug regimens. *Arlene Weintraub*

STER BLOOD-STOPPING VIA VOLCANIC ROCK

MORNING, FRANCIS X. Casey cut himself shaving. The engineer grabbed a piece of volcanic rock he had been studying to see if it could stanch the bleeding. It did—and now—10 years and several patents later—the erstwhile inventor is commercializing QuikClot. When sprinkled into a wound, the

SMART SNIFFERS FOR CHEMICAL WEAPONS



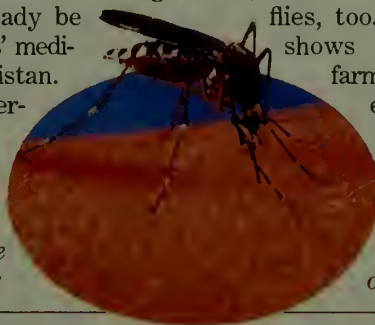
IN EARLY JUNE, A ROUTINE ENVIRONMENTAL INSPECTION turned up traces of nerve gas at a military base in Uzbekistan that thousands of U.S. soldiers had passed through. Personnel were immediately evacuated, but it took days to positively identify the deadly traces. That's because today's chemical-weapons detection kits are quick to sense danger but do a poor job of sorting one warfare agent from another. To these kits, which are based on the reaction of natural enzymes to poisons, nerve gas can look just like a less harmful but chemically similar pesticide.

With a grant from the military, biotech startup Semorex Inc. is developing polymers that could inexpensively mimic certain properties of the enzymes in current chemical-detection kits and outperform them in some tasks. Known as molecularly imprinted polymers, or MIPs, these tiny plastic particles are dotted with cavities engineered to trap specific molecules, including organophosphate toxins such as sarin and other nerve gases. Natural enzymes respond more quickly, says Semorex Chief Scientific Officer Bernard Green, but MIPs could actually I.D. the culprit. And detection is just the start. Because the polymers encapsulate the poisons, MIPs could be used in mop-up operations—either sprayed as aerosols, or embedded in fabrics. In the civilian arena, Semorex is designing MIPs that could be ingested, to rid the body of toxins linked to cancer and other diseases. *Neil Gross*

proprietary granular mineral sops up the liquid in blood but leaves behind the clotting factors. "It gives a giant head-start to the body's own ability to clot," says Bart Gullong, vice-president of Z-Medica, Hursey's Newington (Conn.) startup.

The armed forces have taken a special interest in QuikClot because it's so well-suited to harsh battlefield conditions. Manufactured at 800F, it's virtually indestructible, as well as biologically and chemically in-

ert. QuikClot can remain in a wound until treatment begins. And at around \$21 per 3.5-oz. packet, it goes for a fraction of what current-generation coagulants cost. The life-saving gravel can already be found in soldiers' medical kits in Afghanistan. And a civilian version isn't far behind: the FDA approved QuikClot in May. *Catherine Yang*



INNOVATIONS

■ Dialing while driving may be more dangerous than previously thought. A study from the University of Rhode Island says drivers on cell phones may suffer from tunnel vision. Worse, test subjects experienced lessened mental alertness and reduced visual acuity well after their conversations finished. The study, conducted on volunteers using head-mounted eye-movement sensors, could prompt more calls for laws restricting in-car phone use.

■ It seems obvious that everyone's handwriting is unique. But courts have never been entirely comfortable with the idea. Now, using computer analysis of hundreds of features of writing samples—from document layout to line spacing and stroke marks—State University of New York at Buffalo scientists have produced the first peer-reviewed scientific validation that each person's scrawl is special. The finding may boost the use of handwritten evidence in trials.

■ Wild tomatoes produce a substance with the potential to replace DEET, the active ingredient in many mosquito repellents. DEET can cause skin irritation and, in high concentrations, may be unsafe for children, according to the Environmental Protection Agency. The natural substance, called IBI-246, is part of the tomato plant's defense against common field pests, according to Michael Roe, a North Carolina State University entomologist who recognized its bug-begone properties. It fends off ticks, fleas, cockroaches, ants, and flies, too. IBI-246 also shows promise for farm-field use. Roe expects EPA approval this fall.

FEWER BITES: Without DEET



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BuWk 5/2

A GENOME PROJECT AGAINST DISEASE

Claire Fisher is changing germ fighting in the 21st century

In the four years she has led The Institute for Genomic Research (TIGR), Claire M. Fraser and her colleagues have decoded and analyzed the genes of bacteria that cause anthrax, Lyme disease, syphilis, tuberculosis, cholera, meningitis, pneumonia, ulcers, and many others. The work has put TIGR at the forefront of the new field of microbial genomics—the foundation for the treatment and prevention of disease in the 21st century. “In terms of microbial sequencing, the world leader is still TIGR,” says Julian Parkhill, head of microbial sequencing at the other leader in the field, the Wellcome Trust Sanger Institute in Cambridge, England.

Numbers tell the story. Researchers around the world have decoded and published the genes of some 65 microbes; TIGR, located in Rockville, Md., just outside Washington, D.C., is responsible for nearly half of them. The institute has posted an additional 20 on its Web site and is working on 40 more.

Fraser has received some public attention, most recently in May when she announced that TIGR had decoded the genes of the anthrax strain used in last fall’s terrorism episode. But her public

profile contrasts sharply with that of her husband, J. Craig Venter, who founded TIGR a decade ago. She took over TIGR in 1998, when Venter left for Celera Genomics Group, where he led its effort to decode the human genome and became one of the most visible scientists of the 1990s.

Fraser has focused TIGR’s efforts on microbes, mostly those that cause disease. Such research is critically important in the quest to develop new drugs. Most current drug research is based on discoveries made in the last century, says Richard A. Young, professor of biology at the Whitehead Institute and Massachusetts Institute of Technology in Cambridge, Mass. “With complete genome sequences in hand, you can take entirely new approaches to most every problem that can be studied in biology today. The work that TIGR and others are doing is creating the foundation for these future studies.”

TIGR has achieved its preeminent position with thorough research. It invests substantial resources in technology to extract and purify DNA and in the software to analyze the output of its DNA machines. “The quality of the DNA sequence that you generate on these ma-

chines is absolutely dependent on quality of the DNA preparation you use,” Fraser says. As a result, TIGR’s machines are generating longer and clearer DNA sequences than its competitors and doing it at lower cost, she says.

TIGR has nearly doubled in size since Fraser took over. Its staff has grown

TIGR Is Roaring

Under Fisher, The Institute for Genomic Research has become the leader in microbial genomics, the foundation for biological research in the 21st century. TIGR has sequenced nearly half of all the 65 microbial genomes decoded so far.

YEAR	BUDGET (MILLIONS)	HIGHLIGHTS
1998	\$24	<i>Treponema pallidum</i> Causes syphilis
1999	31	<i>Arabidopsis thaliana</i> TIGR was part of an international consortium that sequenced this plant genome, which is critically important in the study of food crops and other plants
2000	31	<i>Vibrio cholerae</i> Causes cholera. <i>Chlamydia trachomatis</i> Causes chlamydia, the most widespread sexually transmitted disease in the U.S.
2001	32	<i>Listeria monocytogenes</i> Causes listeriosis. The microbe is transmitted in hot dogs, lunch meats, and certain soft cheese <i>Streptococcus pneumoniae</i> Causes pneumonia and meningitis
2002	50	Anthrax strain used in bioterror attack in Boca Raton, Fla.



FRASER
WITH
HER
POODLES

CLAIRE M. FRASER

BORN Nov. 5, 1955, Boston

EDUCATION B.S., biology, Rensselaer Polytechnic Institute, 1977; PhD, University at Buffalo, 1981

CURRENT JOB President, The Institute for Genomic Research, the world leader in decoding the genes of disease-causing microbes

CAREER START Studied a class of receptors on the surface of cells that are the targets of many prescription drugs, along with morphine and other narcotics. Entered the field of genomics in the mid-1990s

CONSTANT COMPANIONS Her three standard poodles, Shadow, Cricket, and Marley, who come with her to the office every day

AFTER HOURS Working on the restoration of a 19th-century farmhouse; has recently taken up painting

FAMILY Married to J. Craig Venter, former head of Celera Genomics and now head of the J. Craig Venter Science Foundation

searchers had deciphered the complete genetic code of a free-living organism.

Many had predicted the project would fail. The institute was testing a new and potentially faster method of deciphering genes—a process called shotgun sequencing. The idea was to blast the genome into a mountain of small pieces that would be comparatively easy to sequence—and then put it back together. That simplified the sequencing problem, but replaced it with the difficult challenge of how to reassemble the pieces. That problem was ultimately solved with breakthrough computer software developed by Granger Sutton, who came to the institute from Bell Laboratories. The sequencing of *Haemophilus*, which Venter calls “the experiment that changed the world,” gave him the confidence to apply the methodology to the human genome.

As Fraser began to decode the genes of more microbes, she made a profound discovery. Nearly all of the microbes’ genomes contained a large store of unknown genes—making up about one-third of the organisms’ genes. “That was the biggest shock,” she says. “At that point, we

from 170 to 325, including about 30 jobs. The institute’s annual budget—fully all of which comes from competition for grants from the National Institutes of Health, Energy Dept., and National Science Foundation—is about \$24 million this year, up from \$24 million in 1998.

public recognition has been slow coming, scientific recognition hasn’t. Fraser has published 130 papers and sits on numerous scientific committees, NIH review boards, and editorial boards. She is one of the few women to head a major research institute. That’s more than most scientists achieve in a lifetime—and Fraser is only 46.

She is the daughter of a high-school principal and an elementary school teacher. Fraser was born in Boston and grew up in Saugus, a Boston suburb. Her early interest in science left her feeling like an outcast in high school, but it changed when she went to study biology at Rensselaer Polytechnic Institute in Troy, N.Y. “She had an unbelievable memory and had a passion for science and research,” says Barry Martinelli, an RPI hockey player who dated

Fraser for several years. “She’d go to the hockey games and go to the parties, and then go back and hit the books for 48 hours straight. Scientists tend to be very rigid. She isn’t like that,” says Martinelli, now associate director of athletics at the University of Western Ontario in London, Ont.

At RPI, Fraser discovered the joys of research. She went on to get a PhD in pharmacology at the University at Buffalo. There she met Venter, who was an assistant professor. They married in 1981, and worked together on the biology of so-called G protein-coupled receptors, which are involved in many biological processes. In 1985, they moved to NIH, in Bethesda, Md. Venter began to study genomes, while Fraser continued work on receptors. In 1992, Venter left the NIH to found TIGR. Fraser became the institute’s vice-president and the director of its microbial genomics program.

TIGR’s first major success came in 1995, when it determined the complete genetic sequence of a microbe called *Haemophilus influenzae*, a cause of ear infections and meningitis in children. It was a landmark—the first time re-

searchers had deciphered the complete genetic code of a free-living organism. Many had predicted the project would fail. The institute was testing a new and potentially faster method of deciphering genes—a process called shotgun sequencing. The idea was to blast the genome into a mountain of small pieces that would be comparatively easy to sequence—and then put it back together. That simplified the sequencing problem, but replaced it with the difficult challenge of how to reassemble the pieces. That problem was ultimately solved with breakthrough computer software developed by Granger Sutton, who came to the institute from Bell Laboratories. The sequencing of *Haemophilus*, which Venter calls “the experiment that changed the world,” gave him the confidence to apply the methodology to the human genome.

As Fraser began to decode the genes of more microbes, she made a profound discovery. Nearly all of the microbes’ genomes contained a large store of unknown genes—making up about one-third of the organisms’ genes. “That was the biggest shock,” she says. “At that point, we gave up any notion that if we had all the genes, we’d know how something worked.” TIGR and others are now working to determine the functions of these newly discovered genes.

TIGR’s research has had few practical applications yet—it’s early in the game—but one example suggests where it could lead. Scientists at the biotechnology company Chiron Corp. contracted with TIGR—in one of the institute’s rare non-public ventures—to decode the genome for *Neisseria meningitidis*, a cause of meningitis. Analysis of that genome led the company to new meningitis vaccines, which are now in development.

Fraser has little patience for formality or for hierarchy. The institute’s organizational lines mostly run horizontally, not vertically. “There are no walls, no departmental barriers,” she says. “We’re what you might find in industry, where groups are formed to tackle a particular problem. And when the task is completed, the groups go away and new groups are formed.” Teamwork is crucial to the institute’s success. “We’re not a good place for loners, people who

are more comfortable doing traditional biology," she says. "This is large-scale biology, and that means people have to come together to solve problems."

Samir Kaul prospered under that approach. He had only a master's degree in biology when he joined TIGR to work on a project to sequence *Arabidopsis thaliana*, a mustard plant important in agricultural research. Despite his lack of a PhD, he was quickly promoted to project director. "They recognize talent, and they cultivate it," says Kaul, who left TIGR for Harvard Business School and has just joined a venture capital firm in Boston. "I worked a lot of late hours, and you do it because you don't want to disappoint her."

One of the remarkable things about Fraser's achievement at TIGR is that she draws the highest level of work out of her staff without the promise of stock options, bonuses, or sales commissions. TIGR is a not-for-profit institute. Because nearly all of its work has been funded by the government, its research results are freely available to anyone with an Internet connection.

Fraser's work has consumed much of the time that might have gone into other, non-professional pursuits. Venter has one child from a previous marriage, but she and Venter do not have children. "There was a time when it might have happened, and it didn't, and I don't regret that," she says. The demands of her work, she says, simply made it impossible for her to be the kind of parent she wanted to be.

She does have a few diversions. She shares her office with three poodles—Shadow, Cricket, and Marley—whom she loads into her Range Rover with her every morning and evening. Instead of displaying her degrees in her office, she has framed copies of the dogs' obedience-school graduation certificates. For the past six months, Fraser has supervised the restoration of a 19th century farmhouse she and Venter bought in Maryland's Montgomery County. "I have had a blast doing it. My disappointment is that I haven't been able to do more of the hands-on work myself. My father was a handyman, and I think I picked that up from him."

Several years ago, Fraser started to paint. She has mused about quitting and going back to school. "I'd like to re-learn physics," she says. Or maybe chemical engineering, she adds. Or nanotechnology, or interior design, or landscape architecture. Or, to put it another way, Fraser is one of those uncommon individuals with a broad intellectual curiosity about the world and how it works. That, more than anything else, may explain her success.

By Paul Raeburn in Rockville, Md.

People



MULTI MIKES: West, who holds a PhD in biology, advocates therapeutic cloning

ENTREPRENEURS

CLONING: HUCKSTER OR HERO?

Michael West's optimistic predictions have tripped him

Michael D. West, the head of Advanced Cell Technology Inc., has placed himself where few of his colleagues want to be: smack in the eye of the raging political and ethical storm over human cloning. The 49-year-old scientist and entrepreneur is the biotech industry's self-appointed pitchman for cloning human embryos to help treat disease—not to create people. He has testified on Capitol Hill and spoken often and at length with the media. He has also, perhaps recklessly, rushed to publish some of his lab's findings in the popular press rather than wait for scientific journals to review them.

Anything, it seems, to get the word

out about what may be possible achieved with cloned cells: treatment for debilitating diseases such as Parkinson's, diabetes, or Alzheimer's. "We are trying to save the lives of our fellow human beings who have no hope today," he says. "I really believe that I can convince [opponents] that this is the right thing to do."

But West's outspokenness has put his company in jeopardy. Its financing is dubious and its credibility is strained. Nor has it won many over to his cause. Last year President George W. Bush called for a ban on all human cloning and the House of Representatives passed such a bill.

Senate, though, support is
ing for a measure that
allow therapeutic cloning.
would put ACT in a much
r position; it would have a
al head start in what could
multibillion dollar industry.
f the Senate leaves the is-
unresolved, which is likely,
will continue to struggle.
anwhile, opponents of
ag are going after what
er resources ACT does have.
ay, conservative members
ngress accused the company
ud and demanded that the
dent rescind \$1.9 million in
al grants to study animal

g. The charges stem from an April
g by the Health & Human Ser-
Dept. that ACT misused \$150,000,
y by buying equipment not includ-
its grant application. ACT says it
verbal approval for the purchases.
has agreed to pay back the
00, but expects to be able to draw
the rest of the funds. "The point
portray ACT as unethical," says
"It infuriates me."

l it couldn't come at a worse time.
privately held company's coffers
early empty and its cloning exper-
s on hold as West scrounges to
cash. "Notoriety does not usually
t institutional venture capital,"
Michael Lytton, a general partner
ord Bioscience Partners, a Boston
e firm. Indeed, one major investor
out of a deal after Bush's pro-
ment. Another, Anthem Venture
ers in Santa Monica, Calif., is
ing an investment, but has not come
ens with ACT. The only other U.S.
ny known to have experimented
human cloning is Geron Corp.,
West founded in 1990, helped take
seven years later, and left in 1998.
which West controls through a
ty stake in its holding company, is
surviving. Based in Worcester,
SACT brings in about \$2 million a
om licensing patents and cloning
cattle for farmers who hope the
Dr Drug Administration will soon
ce the sale of milk and meat from
e animals. If that happens, West
rt could receive "millions of dol-
orth of orders" from farmers.

le West, who
PhD in biol-
aput his com-
t the van-
d of human-
research, his
ination has
all those who
oe his natu-
als. Mention
ame to fel-

Michael West



BORN Apr. 28, 1953,
Niles, Mich.

EDUCATION BS, psychology,
Rensselaer
Polytechnic Institute, '76;
MS, biology, Andrews
University, '82; PhD, biology,
Baylor University, '89.

POSITION President and
CEO, Advanced
Cell Technology.

NOTORIETY Announced in
1999 that ACT
had tried and failed to create

embryonic stem cells by placing
a human cell in a cow egg;
falsely claimed to have cloned
a human embryo in November.

UNDER ATTACK Critic William
Kristol wrote
that there are "two grave threats
to a dignified human future: ter-
rorism and cloning."

FAMILY Married to second
wife, Karen. They have
four children under age 3,
including 7-month-old triplets;
West won't say if they were con-
ceived with the help of science.

low scientists and they either sigh,
cringe, or ask, "What has he done now?"
Their major complaint is with his com-
pany's science. If it were stronger and he
were more circumspect, West might be a
better standard-bearer for cloning re-
search, they argue. "I never saw any
science that he did that was that inter-
esting," says Carole Greider, professor
of molecular biology and genetics at
Johns Hopkins University and a former
Geron adviser. "He was always just pro-
moting ideas."

The latest brouhaha over ACT's re-
search occurred in November when the
company published a paper in an on-
line scientific journal claiming to have
cloned the first human embryo. In fact,
the experiment failed because the cells
quickly died. Other scientists were out-
raged by what one called West's grand-
standing: The paper, which might not
have been approved for publication in a
more established journal, received plen-
ty of attention, most of it negative.

It wasn't the first time West has
erred on the wrong side of caution. In
1999, he announced that the company
had years earlier placed a human cell
into a cow egg in an attempt to clone a
human embryo. That experiment was
also unsuccessful. Even so, "it raised
the question of whether you were cre-
ating some kind of
chimeric organism," says
Steven Holtzman, CEO of
Infinity Pharmaceuticals
Inc. in Boston, who was
then a member of Presi-
dent Bill Clinton's na-

tional bioethics advisory commission.
West says he went public because "it
would look awful if we were doing these
things in secret."

While West admits stoking hype
around his company, he insists it's for
the right reasons. Since cloned embry-
onic stem cells might be able to develop
into any kind of adult cell that an ailing
person may need, "there's not an area of
medicine that this won't potentially im-
pact," he says. Many who know West
describe him as overly optimistic. "I
think some of the things he has done
have been mistakes," says Vincent J.
Cristofalo, a Thomas Jefferson Univer-
sity medical school professor and a
member of Geron's scientific advisory
board. "But I don't think he's trying to
pull the wool over everyone's eyes."

West has always been as much a
businessman as a researcher. After two
years in medical school, he dropped out
to start Geron, a biotech firm that would
study the aging of cells. Seven years
later, in 1997, Geron went public and
West became a millionaire. Then things
got messy, and in 1998 he abruptly re-
signed and sold his stock for some \$2
million. He used about half of that to
buy ACT from Charoen Pokphand Group,
a Thai conglomerate, in 1999. West ad-
mits that his departure from Geron was
not amicable. And the company

has since filed a claim with
the U.S. Patent Office
charging ACT with infring-
ing the patents that West
helped Geron win. Execu-
tives at Geron declined to
comment.

But it's the political bat-
tle that matters most. ACT's
prospects will remain dim
until lawmakers give their

O.K. for therapeutic cloning and Pres-
ident Bush seconds it. In the mean-
time, West can only hope that the FDA
will clear the way for him to turn his
cattle-cloning business into a cash cow.

By Faith Keenan in Worcester, Mass.



**Advanced Cell
Technology has caught
the imagination of farmers, who
now pay to clone prize livestock**

TWO OF A KIND: George and Charlie

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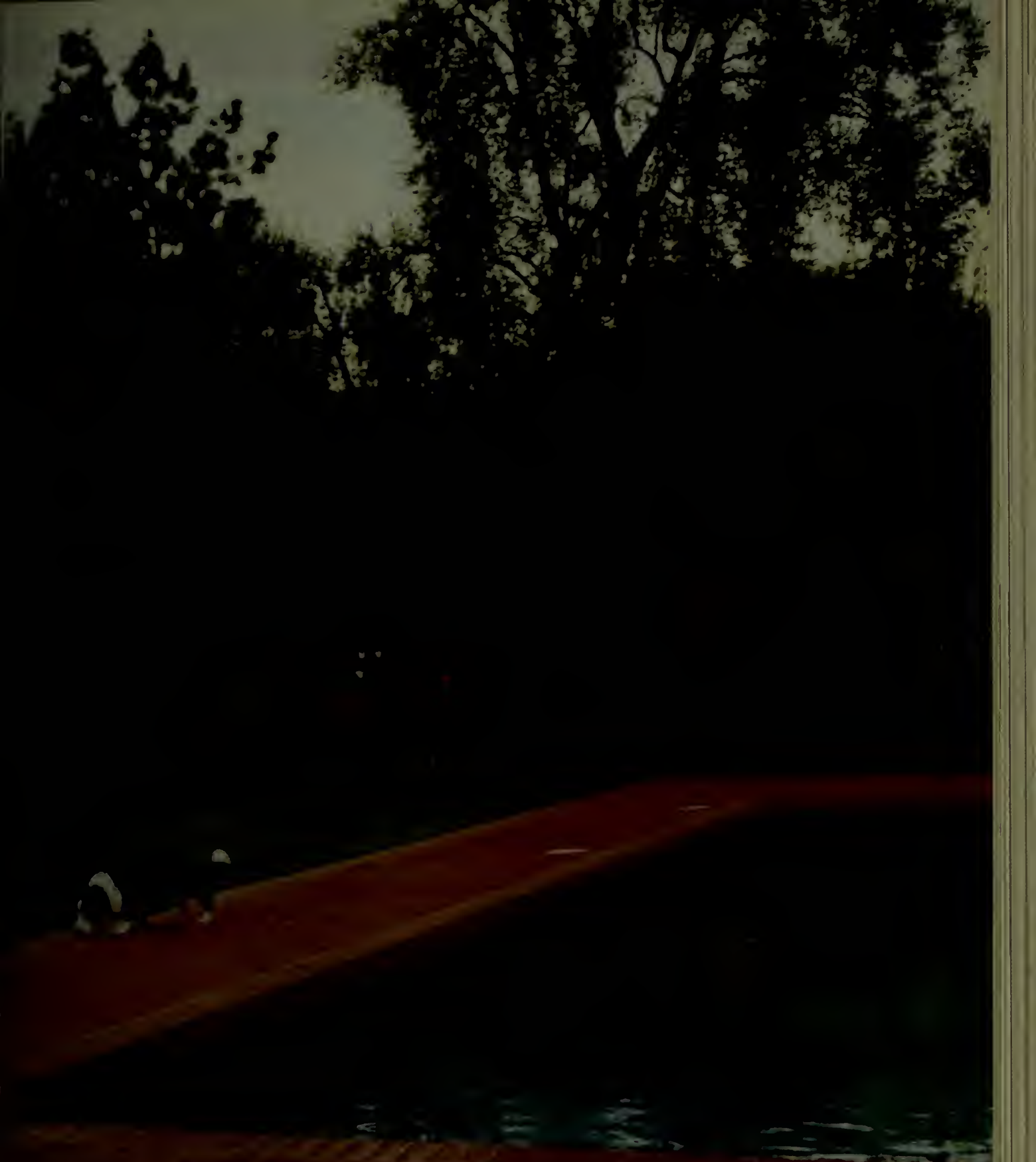
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COMMENTARY

By Rich Miller

CONSUMERS SHOPPED. WILL THEY DROP?

As the U.S. economy slid into recession last year, there was one shaft of light penetrating the econo-funk. Consumers had an uncanny ability to keep on spending right through the tech bust, a market dip, September 11, and the collapse of corporate profits. Americans' purchases of everything from cars to homes to electronics gear helped the economy weather the downturn. "The consumer was the hero in 2001," says economist James Glassman of J.P. Morgan Securities.

Now the hero's halo is looking tarnished, with sobering implications for the still-struggling recovery. On June 13, the Commerce Dept. reported that retail sales slumped 0.9% in May, their biggest decline in six months. The University of Michigan weighed in the next day with the news that consumer confidence for June dipped to its lowest level of the year. And as if that weren't enough, both Apple Computer Inc. and Advanced Micro Devices Inc. singled out weak consumer spending in issuing profit warnings on June 18.

Of course, the doom-and-gloomers have been counting consumers out ever since the economy started faltering a year-and-a-half ago—and they have been wrong every time. This time, though, they may be right. The reason: The strong wage gains that continued in the recession may be petering out.

Those gains—after adjusting for inflation, average hourly earnings rose 3% in 2001—were a key reason why consumers kept spending so freely during the downturn. Normally, wages take a hit when the economy heads south. But they didn't this time, in part because companies were still smarting from the supertight labor markets of the late 1990s and didn't want to risk losing valued workers. At the same time, inflation was falling, further

boosting consumer purchasing power. The drop in energy prices alone is reckoned to have pumped up pocketbooks by \$50 billion in 2001.

Now, however, rising unemployment and falling corporate profits appear to be taking their toll on wages at last. After climbing steadily last year, real average hourly earnings have turned down, dipping two cents to \$8.12 in May, according to Labor Dept. data. Shell-shocked by last year's plunge in profits, companies are taking a harder line in salary negotiations with their workers. And with unemployment nearly two percentage points higher than its 3.9% pre-recession low, they can get away with it. Manpower Inc. CEO Jeffrey A. Joerres, whose temporary workers are on the front line of the labor market, says the average temp is making a nickel less an hour than last fall. He sees no change in that for the next six months.

An uptick in inflation is also eating into consumer purchasing power. Although consumer prices held steady in May, they've still risen at an annualized rate of nearly 3.4% over the past three months. Energy prices alone have skyrocketed 35% over the same period, despite a small dip in May.

To make matters worse, the slowdown in workers' real wages comes just as some other props to consumer spending are also giving way, notes Edward F. McKelvey, senior economist at Goldman, Sachs & Co. The \$40 billion tax rebate last summer and big refunds early this year boosted buying power. But now those effects are waning. Consumers will have to wait until 2004 for the next big dollop of cash under Presi-



dent Bush's 10-year tax-cut plan.

The kick to consumption from mortgage refinancing by homeowners is also fading. Last year's refi boom pumped \$80 billion into homeowner pockets. But with mortgage rates above last year's lows, the refinancing frenzy has cooled off. The Mortgage Bankers' Assn. refinancing index stood at 1,764 in the week ended June 14, vs. a record high of 5,534 last November.

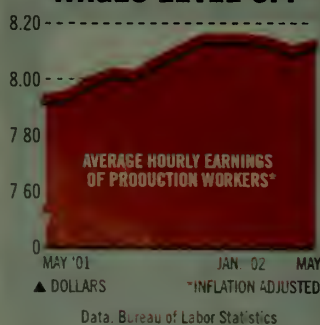
What's more, the sagging stock market is eating into the wealth of already stretched consumers. Economists reckon that consumers eventually reduce spending by three to five cents for every dollar decline in the wealth.

So does all that mean that consumer spending is about to collapse and the economy is headed for a dreaded double-dip recession? Not necessarily. The housing market is still superstrong. And early reports from retailers and auto dealers suggest that business bounced back in June after sliding in May.

Still, there's no doubt that consumers are tired after last year's heroics. Saving the economy from recession was one thing. But counting on consumers to propel the recovery at a time when wage gains are ebbing may be too much to ask, even for America's millions of avid mall rats.

Miller covers the economy from Washington

WAGES LEVEL OFF



TODAY

Reduce manufacturing
waste going to landfills

TOMORROW

Reduce land going
to waste

TOYOTA



Each year Toyota builds more than one million vehicles in North America. This means that we use a lot of resources — steel, aluminum, and plastics, for instance. But at Toyota, large scale manufacturing doesn't mean large scale waste.

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SMALL-TOWN PAPERS, BIG-TIME PROFITS

Lee Enterprises CEO Mary Junck has an unusual strategy for media success: Nothing but newsprint

When Mary E. Junck was running *The Baltimore Sun*, *Newsday*, and other newspapers owned by Times Mirror Co., after-hours life meant black-tie affairs at the Baltimore Symphony Orchestra or tony fund-raisers for Johns Hopkins University. Now, as chief executive of Lee Enterprises Inc. in Davenport, Iowa, Junck stages garage sales

for her daughter's Girl Scouts troop or teaches Sunday school. True, small-town life is lower-key, admits Junck, a 54-year-old Iowa native. But "we're not totally removed from civilization."

Big Media city slickers could learn plenty from Junck and the \$540 million-a-year, 45-newspaper chain she has run for 18 months. For one thing, readership—in such towns as Baraboo, Wis.; Albany, Ore.; and Rapid City, S.D.—is growing. For another, Lee is a money-making machine, and this year it's on track to post a 31% rise in operating income, to \$114 million. What's more, while the stock in bigger companies has sagged from the ad slump and expansion

efforts, Lee's stock rose after its big purchase ever—Howard Publication \$694 million, in April—and now trades about \$36 a share. That's close to all-time high in May of just under \$40 and up about 11% in the last year.

Establishment lifestyle isn't the thing Junck has tossed. She has taken a strategic tack that's heresy in some Big Media circles. Instead of buying TV, radio, and print properties, Junck has narrowed Lee's focus to just newspapers. The company dumped 16 TV stations in the past two years and used the proceeds to buy more small and midsize newspapers, getting 30,000 to 125,000 circulation dailies. Lee's papers, now in 18 states, comprise the U.S.'s 12th-largest circulation with daily circulation of more than 1 million. And it's managing just fine without out TV or radio stations to cross-promote or share advertising revenue with. Says Junck: "It's much harder to converge than it seems."

It helps, of course, that Junck's papers are potent little cash machines. Such papers as Iowa's *Muscatine*



MARY E. JUNK

TITLE CEO, Lee Enterprises.

AGE 54.

PERSONAL Raised on a family farm near Ogden, Iowa. Two older brothers, one a farmer and the other a high school teacher in Des Moines.

FAMILY Husband, Ralph Gibson, owns plumbing, heating, and air-conditioning supply company. One daughter, 13. Or stepson, 27.

EDUCATION B.A. in English from Valparaiso University, 1969. Master's in journalism, University of North Carolina at Chapel Hill, 1971.

CAREER Started out as \$10,000-a-year marketing researcher in Charlotte rising to corporate management at Knight-Ridder. Hired as publisher in St. Paul and then at Times Mirror's *Baltimore Sun*. Promoted in 1997 to executive vice-president at Times Mirror Co. and president of Times Mirror Eastern Newspapers. Overseeing *Newsday* and the *Hartford Courant*. Joined Lee Enterprises in 1999 as COO. Promoted to top job two years later.

HOBBIES Leading Girl Scouts in Pleasant Valley, Iowa; teaching Sunday school.

Data: Lee Enterprises. *BusinessWeek*

**KRIENS WANTS TO
SELL A MUCH
BROADER RANGE
OF PRODUCTS**



INTERNET GEAR

WHY JUNIPER MUST BRANCH OUT

High-end routers made the company. That's no longer enough

Juniper Networks Inc. was renowned during the tech boom for being the only startup that ever took on mighty Cisco Systems Inc. and won. How? It focused like a laser on one thing: building the best jumbo routers for directing traffic around the Internet. On average, its top routers were twice as expensive as Cisco's, yet four times as fast. Sales skyrocketed during the tech boom, and Juniper hit 31% market share in March, 2001.

But the telecom depression has put an end to the good times for Juniper. Many of the upstarts that bought its gear have gone out of business, and even large customers such as WorldCom Inc. are cutting back. On July 11, analysts expect Juniper to announce sec-

ond-quarter sales of \$110 million, down 46% from the year-earlier period. Its share price, which peaked at \$243 in late 2000, has dropped 97%, to \$7.53.

Now, CEO Scott Kriens is rerouting Juniper. With the company's survival at stake, he's laying out a bold plan to shift Juniper away from the acute focus that made it a success. Instead, Kriens is expanding into a broad range of networking gear that he hopes will boost revenues and profits in the years ahead. Juniper took an important step toward that strategy on May 20 when it said it would pay \$740 million in cash and stock for Siemens' Unisphere Networks, which makes small routers that handle specialized tasks such as directing broadband traffic. "The only path to

—which Mark Twain once wrote and the *Chippewa* (Wis.) *Herald* their markets in ways big-city papers can only envy. Where the *Chicago* might reach 20% of households markets, Lee papers go to more 60% of their households. Often the game in town for local car dealers grocers, Lee isn't suffering much the slump in national ads.

ill, even as she gazes out at the Mississippi River lazing by her window, Junck can't escape the pressures that beset most papers these days. Like many others, Lee's daily circulation slipped for much of the 1990s only recently turned around, rising in the six-month period ended March. By contrast, *Los Angeles Times* circulation plunged 5.3%, to 985,798. Hard times have nicked Lee's profits, the pinch should be short-lived. Operating income slipped 16% in the year ended Sept. 30, 2001, to \$86 million, as revenue inched up just 2.2%, to \$441.15 million. Through May this year, ad sales down some 3.3%, though Lee executives declines are slowing. Thanks to the hard deal, moreover, Merrill Lynch analyst Lauren Rich Fine expects Lee's revenues to jump 22%, to \$8 million. For \$5.3 billion Tribune such results are little more than rounding errors. But Lee's margins put convergence-obsessed Tribune's margins to shame. "I don't think size is everything," says Junck.

The folksy CEO owes much to the grit though. She got her start at Knight-Ridder Inc., rising to top jobs in Miami and St. Paul. A go-getter, she never had trouble. Says Knight-Ridder's P. Anthony Ridder: "She would call me and say, 'I've got a problem, and this is what I plan to do.'" Junck jumped to *The Baltimore Sun* in 1993. She rose to publisher of *The Baltimore Sun*—a job she held despite occasional friction with reporters over stories critical of local businesses. Then, as president of Times Mirror Eastern Newspapers, she found she didn't like "corporate life" there. She joined as chief operating officer in May, just before Times Mirror sold out Tribune Co.

Junck misses some things about big newspapers. Having once aspired to be a reporter, she still admires the important journalism going on at big papers. "But she says her papers, too, are the 'higher calling' and touch their readers closely with their tight focus on issues, from how schools protect themselves from sexual predators to festering tensions. "What we do is important to [our] democracy," she says. Still, idealistic Iowa farm girl? Junck didn't bristle at the idea.

by Joseph Weber in Davenport, Iowa

The acquisition of Unisphere will be a boost both for sagging sales and reaching new customers

recovery is action," says Kriens.

And not just one action. Kriens also is pushing Juniper's engineers to develop routers that will help mobile-phone companies manage the growing volume of data traffic on their networks. And last November, he paid \$200 million for Pacific Broadband Communications, putting Juniper into the market for routers that handle cable-modem traffic.

At the same time that Kriens overhauls Juniper's product lineup, he's wooing a different kind of customer. Juniper built much of its success on catering to upstarts, including Metromedia Fiber Network and Yipes Communications, that have filed for bankruptcy. Now, Kriens needs to generate business from more stable telecom companies, including local-phone giants SBC Communications Inc.

they have to go through some growing pains," says Doug Junkins, vice-president of Web-hosting company Verio Inc., a Juniper customer.

Still, Kriens stands a good chance of pulling off a rare telecom turnaround. For starters, he has plenty of dough. Even after spending \$375 million in cash for Unisphere, he has \$725 million left. His operating loss for the first quarter was only \$15 million, a burn rate that's sustainable for 10 years. Juniper has \$1.2 billion in long-term debt, but it won't start coming due until 2007. "Juniper's not going away," says analyst Steven Kamman of CIBC WorldMarkets.

Meantime, Kriens's broader-is-better strategy has promise, even if its execution is tricky. With the closing of the Unisphere deal, expected in July, Juniper

and customers say Unisphere's routers are more flexible than those made by Cisco and other rivals. Its broadband routers, for example, let phone companies easily change the amount of bandwidth they allocate to customers. Unisphere has emerged as the best-in-class, but [Unisphere] might be a little ahead of Cisco," says David Garbin, vice-president of Cable & Wireless PLC, which is considering purchasing from Cisco and Unisphere.

Just as important, Kriens may be motivated from the fact that telecom carriers loath to rely entirely on one supplier. Phone companies want a viable alternative to Cisco, which has 65% of the markets for high-speed and specialized telecom routers. Together, Juniper and Unisphere have nearly 25% of the market. Carriers may keep feeding the business just to make sure that they don't get more control of the market. "There's no way carriers will let themselves to deal with a monopoly," says CIBC's Kamman.

There's evidence of that already. The deal is close to finalizing a hefty portion of its routers to Verizon, according to two Wall Street analysts and a telecom industry executive. The analysts estimate that the deal is worth \$200 million over the next two years. Separately, Unisphere has signed a significant deal with France Télécom. Juniper would not comment on the potential deal.

To be sure, Kriens has plenty of challenges ahead. In Unisphere, he is facing the most complex merger-integration he has ever handled. The Siemens unit has 600 employees, making it four times as large as the staff of Juniper's largest acquisition. Worse, Unisphere is based in Westford, Mass., a company far away from Juniper's headquarters in Sunnyvale, Calif. Even as Kriens toils to integrate the acquisition, he needs to get his engineers cranking out top-flight products in a wide swath of categories. Kriens remains at the mercy of telecom players who are hellbent on reducing their spending on new gear.

Still, Kriens is determined to succeed and build Juniper into a stronger company once again. "We'll be there thick and thin," he says. "When the markets recover, the winners will have been built in times like these." Juniper just may be one of those winners.

By Ben Elgin in Sunnyvale, Calif.

REBUILDING JUNIPER

Juniper Networks is the only Net equipment maker to rival Cisco, grabbing 31% of the high-end router market in Mar. 2001. But the downturn sent sales tumbling. Here's CEO Scott Kriens's turn-around plan.

ATTRACT NEW CUSTOMERS

Many upstart telecom customers are in trouble. Juniper hopes to sell more gear to big carriers in the U.S. and abroad. But it faces formidable foes in Lucent and Nortel.

KEEP CONSERVING CASH

Juniper still has \$725 million in cash. Its first quarter operating loss was \$15 million, and its \$1.2 billion in long-term debt doesn't come due until 2007.

and Verizon Communications. He's doing that by hiring more telecom veterans, including Nortel Networks Ltd.'s Lloyd Carney, who joined as chief operating officer in January.

The risk is that Juniper will become a jack of all routers, master of none. Since the company's founding six years ago, its engineers, which make up 40% of the 1,100-person workforce, have devoted much of their energy to high-end routers. Spreading that talent across many different products risks compromising the quality of the offerings. And mediocre products won't cut it. Juniper faces large, entrenched rivals in every market it's entering. Juniper "surprised everyone with what they were able to accomplish, but now

DIVERSIFY PRODUCT LINES

Juniper made buys to move into cable-modem routers that direct broadband traffic. But Cisco and Motorola pose stiff competition in this \$400 million market.

REVAMP THE WORKFORCE

Juniper is beefing up its marketing staff by hiring outsiders. The company is also trimming jobs where there's overlap with the companies it just bought.

will have a fast-growing upstart to help its sagging sales. Juniper's stand-alone revenues are expected to drop 47%, to \$477 million, this year, while Unisphere's sales are projected to surge 167%, to \$200 million. And in 2003, the specialized router market that Unisphere caters to is expected to grow 17%, to \$2 billion. Assuming Unisphere grows at least as fast as its market, the combined companies' sales are pegged to rise 22% next year, to \$829 million, after a projected decline of 30% this year, to \$677 million.

Unisphere may even gain some share. The company has captured 12% of the market for specialized routers so far in 2002, up from 10% in 2001 and 2% in 2000, according to Synergy Research Group Inc. Industry analysts

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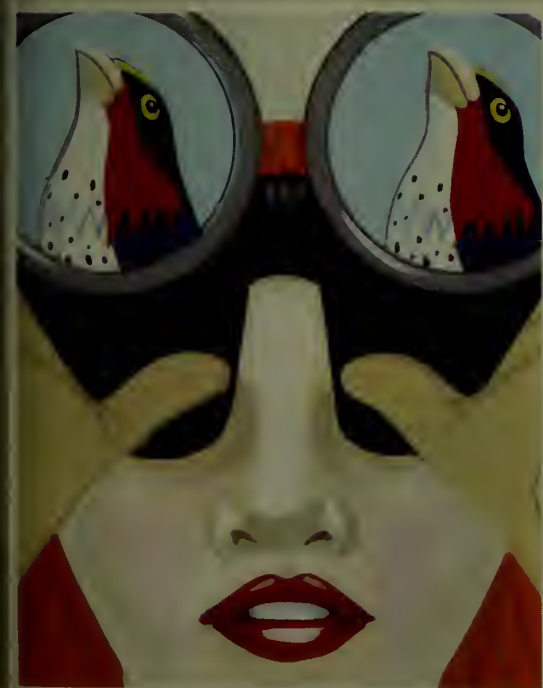
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BusinessWeek

Investor

MAKING LIFE RICHER

2002 Midyear INVESTMENT GUIDE



Picking Stocks

Don't bail out yet. With the indexes scraping bottom, it's a classic stock-picker's market

Where To Look Now

BY MARCIA VICKERS

Remember the classic Alka-Seltzer commercial where the big guy sits on a bed, groaning, "I can't believe I ate the whole thing"? Most investors have the same sick feeling about the stock market right now. They can't remember when so many cataclysmic woes converged at once. They're fed up with corrupt chief executives, untrustworthy Wall Street analysts, and numbers-impaired accountants. And their gray hairs have been multiplying over lackluster earnings, a weakening dollar, still-rich valuations, the probability of rising interest rates, terrorism, and even the threat of nuclear war.

With its recent decline, the market has lost four years of bull-market gains. The Standard & Poor's 500-stock index is down 9.6% through June 18,





after falling 10% and 13% in 2000 and 2001, respectively. The Nasdaq is down 70% from its record high in March, 2000. And although nobody thought the indexes would test their post-September 11 lows, both the Nasdaq and the S&P have.

No wonder investors' stomachs are churning. They can't believe they swallowed whole the idea that stocks would always go up. Or such bull-market dogmas as "buy and hold" or "buy on the dips." Indeed, many stocks they thought were cheap have done nothing but sink further. "I can't remember a time that was so challenging for investors. There are no clear themes like in the '90s," says Michael E. Kenneally, chief investment officer at Banc of America Capital Management.

Is it time to head for the exits? After all, parking cash in a savings account or plowing it into, say, a 19th century farmhouse seems mighty appealing these days. But if contrarian sentiments, like Warren Buffett's "You try to be greedy when others are fearful, and fearful when others are greedy," are any guide, it could be time to jump in. (Try this on for size: Ozzie Osbourne's MTV show, *The Osbournes*, has been trouncing CNBC's *Squawk Box* in the TV ratings lately.) Many strategists say the carnage indicates the market is in the midst of a bottoming out. Says Tobias M. Levkovich, institutional equity strategist at Salomon Smith Barney, "The best time to buy clothes is when there's a half-price sale at Macy's. The same with the market, if you pick the right stocks."

BusinessWeek sees stocks ending the year up in the single digits—perhaps around 2%. That's because the economy is on an upswing, and profits should look rosier in the final two quarters (page 108). Even a modest gain in stocks would be a huge relief for investors who lost money for a couple years. But it won't give index funds much mojo. In fact, investors, who harvested the 650% rise in the S&P from 1982 to 2000, may now have to rethink their approach to investing. Even when the market takes off again, stocks are unlikely to regain their late-'90s glory. Most strategists say they're more likely to post annual gains of around 7% or 8%—even less than the 10% annual average over the past half century.

It's a classic stock-picker's market. More than ever, investors need to do their homework. "Spend at least as much time researching a stock as you would choosing a refrigerator," as Peter Lynch, the former Fidelity Magellan manager and legendary stock-picker, says. In other words, find a top-of-the-line, turbocharged Sub-Zero selling at wholesale. Searching for stocks that can

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ILLUSTRATIONS BY
Alison Seiffer

MIDYEAR INVESTMENT GUIDE

beat the S&P 500 means sticking to companies with sound fundamentals and uncomplicated balance sheets and avoiding those with any hint of a regulatory investigation. Companies should have solid long-term growth potential and be in strong or improving industries. Their price-earnings ratios should be below their industry's average. Ideally, they should be substantially off their 52-week highs.

"Investors have the erroneous notion that high risk means high return," says Merrill Lynch's chief U.S. strategist, Richard Bernstein, who likes "boring" companies with safe dividends. In fact, dividend stocks get high marks across the board. "A larger and larger portion of total equity returns will be comprised of income flow," adds James Paulsen, chief investment officer for Wells Capital Management.

Investors should take comfort that the market may not be as bad as it seems. Half of the S&P 500 stocks are up for the year. Except for tech and telecom, there has been a stealth bull market with many companies racking up gains—especially the likes of homebuilders, retailers, manufacturers, and utilities that were shunned during the Nasdaq craze. The Morgan Stanley Cyclical Index is up 6% for the year. Valuations may look lofty with the S&P trading at about 21 times forward earnings, vs. a historic average of 15. But take out tech, and it's now 18.

Smaller stocks, especially in the value camp, have been outperforming the larger. The S&P 400 Barra Value index, a mid-cap measure, is up 5% this year, while the Russell 2000 Value, a measure of small caps, is up 6%. But some strategists say many battered-down large caps are becoming the better buys. "The valuation gap between small- and large-cap stocks has narrowed significantly. Large caps, especially multi-nationals, will be the primary beneficiaries of a global turnaround and weak dollar," says Charles Pradilla, chief investment strategist at SG Cowen.

Although most pros still lean toward value stocks, there's a caveat. After their big run-up in the past two years, many of these stocks are losing steam. Says Morgan Stanley Chief Investment Strategist Steven M. Galbraith: "We

Why It's a Stock-Picker's Market

- As long as investor confidence remains in the doldrums, the market isn't likely to stage an overall lift or sustainable rally.
- With earnings and accounting methods under scrutiny, investors have to be more selective than ever in choosing stocks.
- Broad strategies such as growth or value aren't working. Pros say value stocks are often overvalued, and many growth stocks have stopped growing.
- Index investing just isn't cutting it. It has now been the longest wait for a new high for the Standard & Poor's 500-stock Index since the bull market began in '82.
- Sector investing is shaky. There are bad companies in good sectors and vice-versa. The same goes for large caps vs. small caps.

believe the fat value-over-growth style pite already been hit out of the park." Famed hedge fund manager Leon Cooperman agrees: "growth stocks aren't growing, and value stocks are overvalued."

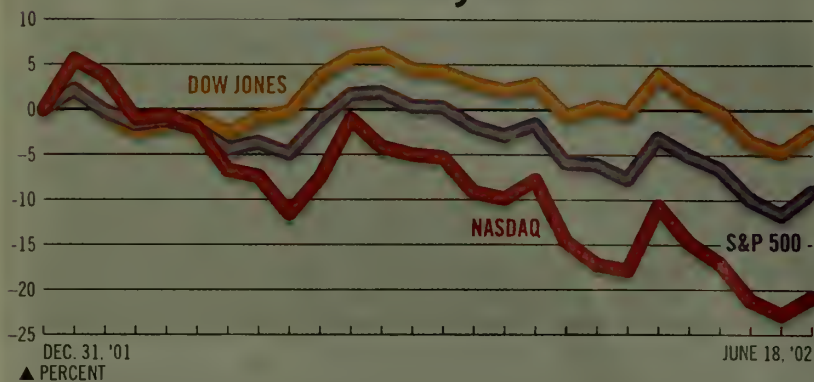
The market is littered with wealth-threatening "value traps"—former highfliers like World Lucent Technologies, and Tyco International have been pulverized. To many investors, finding such big-name stocks so low seems akin to covering a Rolex at a tag sale. Trouble is, they have such deep problems that they keep sinking—and some may never rebound.

That's why both buying and selling discipline is vital. "Stocks can tumble 30% or 50% in a few days on bad news, so it's important to know when to sell," says Ken Wolff, chief executive officer of MTrader.com, a Paradise (Calif.) trading firm. It can also be smart to buy good companies when an entire sector plummets on bad news. On June 12, when questions arose over advertising giant Omnicom Group's accounting, investors drove the stock down almost 20%. They slashed other big ad stocks like WPP Group and Interpublic Group by the same amount. "It's the cockroach theory: Investors think if one company has a problem, there must be a million more in the fridge," says Levkovich. Likewise, during losers during a sector rally can pay off.

Many pros say the market resembles the recessionary 1970s, when investors had little confidence in earnings and few bought stock. Volatility was low, volatility was high. "At that time everyone knew the only way to make money was to buy at lows and sell on rallies," says Paulsen. A good rule of thumb: Bail out when stock loses, say, 10% or gains more than 20%.

Nobody's advocating day trading or fre

Bottoming Out?





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"Spend at least as much time researching a stock as you would choosing a refrigerator," says Peter Lynch. In this market, that means finding a top-of-the-line model that's selling at wholesale

momentum trading of any sort. But a volatile market can offer good opportunities to reallocate assets—especially for those who still own too many tech stocks. More than ever, having a diversified stock portfolio is essential.

A stock-picker's market is never easy. But the next six months could create some decent opportunities. The biggest—and perhaps only—catalyst will be corporate profits. "That should ultimately drive the market," says Edward M. Kerschner, UBS/Paine-Webber's chief global strategist. After six consecutive down quarters, earnings are finally turning up. Not only is the economy helping, but year-over-year comparisons are getting much easier. According to Thomson First Call, analysts figure third- and fourth-quarter profits will be up 18% and 29%, respectively, over last year. However, Charles L. Hill, First Call's research director, says those estimates could be trimmed. After technology, which has been severely depressed, financials and consumer cyclicals should be up the most. The reason: Consumer spending has been strong.

But because investors are leery about possible accounting shenanigans, there could be a delayed impact on stock prices. "The market is going to wait for earnings rather than an anticipation of earnings recovery," says Kerschner. He and others say the market's turnaround should begin in mid-October, when third-quarter earnings appear.

There's a disconnect in investors' minds between an improving economy and the stock market. "Reasonably good economic news isn't enough," says Merrill's Bernstein. "In order for stocks to appreciate, you need outrageously good news." That said, gross domestic product is still growing at a healthy clip and manufacturing activity is expanding. Even rising interest rates shouldn't stop the market. Experts say a one-percentage-point increase is priced into stocks. As a result, says Morgan Stanley's Galbraith, "The first few takebacks might not carry the same historic weight as other tightening periods."

What's an investor to do? Historically, summer has the lowest returns of any season, according to the *Stock Trader's Almanac*, a market-timers guide. And some strategists are saying a bottoming phase that started in May could last into fall and open a lengthy buying window for investors. "Stocks will get a little cheaper while earnings start to rise," says SG Cowen's Pradilla.

Even longtime bear Byron R. Wien, Morgan

Do Your Homework

In a stock-pickers' market, backing the right horses matters more than ever. Here are some tips:

- 1 **STAY AWAY** from companies with any hint of accounting irregularities or companies that are being targeted by the Securities & Exchange Commission.
- 2 **AVOID** "value traps." It's dangerous to think that just because a company has been beaten down, it can't fall further. Witness WorldCom, Nortel Networks, and Tyco.
- 3 **MAINTAIN** a "sell discipline." Make it a practice to sell automatically when a stock reaches a certain price target or rises by a certain percentage.
- 4 **CUT** your losses. If a stock you pick falls, say, 10%, sell it and move on.
- 5 **STICK** to the very best companies—those that are the top players in their industries and have strong balance sheets.
- 6 **SEEK** strong earnings momentum. Look for companies whose earnings are growing at least as fast as sales—and faster than their peers. Favor companies that are growing earnings organically rather than by acquisition.
- 7 **BEWARE** of too much debt. A good rule of thumb: A company's debt shouldn't be more than 50% of its market cap.
- 8 **WATCH** price-earnings ratios. Look for companies whose p-e is below the industry average.
- 9 **SHUN** companies run by fat-cat managers—the types with a 20-person retinue, a private plane, or who have the company buy them Old Master paintings.
- 10 **CONSIDER** buying companies that pay dividends. They often have stronger, more stable earnings.

Stanley's U.S. investment strategist, likes it right now. He notes that investors are very simplistic—a classic contrarian indicator. According to the NDR Crowd Sentiment Poll from Davis Research in Venice, Fla., only 39.6% of those recently polled are bullish. That compares with 37.6% right after September 11 and 69% in January, 2000, before the Nasdaq crash. Says Wien: "I believe we are approaching at least a temporary low, and a counter-trend move about to take place."

History seems to support this view. The S&P 500 has now fallen in 11 of the last 13 weeks, according to researcher MarketHistory.com. In four out of the six times that has happened, the market climbed over 11% in the next six months. Of course, worries about corporate malfeasance, terrorism, and wars still weigh on the market. Nevertheless, "investors who are waiting for signs of improvement will miss a lot of upside," says Banc of America's Kenneally.

Could be. But in order to capture that upside, you've got to pick the right stocks.

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Boot Up, Log On, Start Picking

Tips on how to prospect online for killer stocks

BY CAROL MARIE CROPPER

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- valueline.com

*All URLs are preceded by www. except for finance.yahoo.com

Every stock you buy seems to head south, but darn if your neighbor isn't making some snappy profits. What does he know that you don't? Perhaps how to trawl for good stocks on the Internet.

We're not recommending chat boards and touts. Many financial Web sites have sophisticated stock screens that let you select search criteria—such as company size and price-to-earnings ratio—so the site can then spit out a list of stocks to fit your requirements.

Want to give it a try? Here are some tips.

■ **Learn by example.** Start with the sample screens available on many sites. A good, simple one is at Quicken.com—and it comes with a helpful tutorial, too.

Before you try to construct your own screen, study what criteria the pros use. For example, Quicken.com's "Popular Searches" section offers several generic screens, from small-cap value to large-cap growth. The major criteria for both are market capitalization—that gets you the size factor—and a series of price ratios: price-to-earnings, price-to-sales, and price-to-book. When these ratios are relatively low, you're looking at value stocks; if high, they're usually growth stocks.

Check out the other criteria displayed, especially the three-year income growth and three-year sales growth rates. For the value stocks, they're sometimes very low or even negative. That's because value stocks are cheap for a reason—often, sales and earnings have been sporadic or volatile. With the growth screen, those same columns show strong double-digit gains. That's what merits their high p-e's.

■ **Customize the screens.** Price-earnings and earnings growth aren't the only important criteria, and perhaps market cap isn't even a concern to you. The screeners allow you to search on dozens

of variables. Look at return-on-equity, or what profits a company is earning on the equity invested in the business. In general, the higher the better. But not always: The company could be pumping up its return by loading up on debt. So some investors prefer return-on-assets. That calculation lets you compare the profitability of companies that have different ratios of debt and equity.

■ **Watch what you mix and match.** In the market, some things don't go together. You're unlikely to find a company with a 50% earnings growth rate selling for a p-e of 6. Or if you specify that the stock must have a \$100 million market cap, don't ask for a 50% growth rate. Some criteria are mutually exclusive. Including one will eliminate any hope of finding a stock that meets the other.

■ **Don't be too demanding.** You can get carried away loading lots of conditions into your search. Your search could get so restrictive that you

wind up with only one stock. Four or five criteria are plenty. Some of the most common measures are market cap, p-e ratio (especially if you don't have reported earnings these days), earnings growth rates, and return on equity. For income-oriented investors—dividend investors—dividend growth rates.

The price-earnings growth ratio, or p-e ratio, is useful for both value and growth investors. When it's low (below 1), you're looking at value. When it's high (above 1), you're looking at growth. The company has at a good price.

With growth stocks, the number may be high, but you can compare it with other growth stocks to see if the price is still reasonable.

Of course, once you've completed the screening, all you have is a list of potential investments. You still need to do fundamental research. You will want to find out what professional analysts are saying about the stock and check the company's Web site and the Securities & Exchange Commission for its financial and earnings reports.

To dig deeper, you may have to pay. Multexinvestor.com and the finance section of Yahoo.com sell analyst research for \$5 a report. Standard & Poor's (spoutlookonline.com) Value Line (valueline.com) provide analysis free of investment-bank conflicts.

With some hard work, a little luck, and a little help for stock screening, who knows? Before long, you could be bragging to your neighbor.



MIDYEAR
INVESTMENT
GUIDE

How can you identify your best
(and worst) suppliers?

View your total spend across
business lines and geographies?

And make sure your contracts
get you the best price?

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The Power to Know.



How the Hotshots Pick their Stocks

Four different money managers—and four different winning strategies

BY LEWIS BRAHAM

If the Chinese calendar had a Year of the Stock-picker, 2002 would be it. Since broad market indexes are all down, only the most discriminating investors have triumphed. With that in mind, BusinessWeek asked some smart stock-pickers how they do it.

Each of these pros has a very different style. John Buckingham, who writes *The Prudent Speculator* newsletter, holds stocks for years. His picks have delivered a 26.2% annualized return over the last decade (as of May 31). Ajay Krishnan, who runs the

Wasatch Ultra Growth Fund, zooms on the fastest growing companies. The fund earned a 17.2% average annual return (through June 14) over the last years. Leah Zell invests abroad.

Liberty Acorn International delivered just 0.5% a year over the last three years. It may not sound impressive

her peers lost nearly 4.9% a year. Arup Datta of Numeric Investors' Small Cap Value Fund has produced a 31.6% a year for the same period. He constantly screens for mispriced stocks, pouncing on them when they show up

MIDYEAR
INVESTMENT
GUIDE

John Buckingham *The Prudent Speculator*

“What accounts for our success is our stomach more than our brains”

YOU COULD CALL JOHN BUCKINGHAM the Cool Hand Luke of Wall Street. The 36-year-old editor of *The Prudent Speculator* never gets upset by market conditions. “What accounts for our success is our stomach more than our brains,” he says. “We will hold on to a stock despite horrendous news about it in the market.” What Buckingham buys: cheap stocks, mainly those trading below book value and at less than one times sales.

To find such bargains, Buckingham feasts on the unloved and misunderstood. One recent purchase is Trenwick Group, a property-and-casualty reinsurer hit hard by September 11 claims and a weak balance sheet. Still, Buckingham sees an opportunity here. “Insurance pricing is better than any time in the last decade,” he says. “Trenwick is also selling assets to shore up its balance sheet.”

Buckingham looks to exploit market volatility as well—which takes him to the beleaguered

semiconductor stocks. “Often, you can buy stocks at \$20 each and sell them at \$60 and then buy them back again at \$20 in the space of a year,” says ESS Technology, which makes chips for DVD



players, is one favorite. “The DVD business is booming, and ESS controls 40% of the DVD chip market,” he says. “It has been blowing earnings expectations, yet it has been beaten up because of the sell-off and some concerns about the company’s accounting.” Buckingham thinks the accounting concerns are overblown.

For similar reasons, he also likes the energy company Williams-Sonoma, which has been hit by fears of mad cow disease. “In this environment, a hint of impropriety is looked at as the gospel,” he says. Buckingham

thinks Williams was unfairly tarnished by allegations that the company tried to corner the California energy market. Williams denies the charges.

Although Buckingham “loves volatility,” he does control risk in his portfolio through diversification and by trimming back his winners. Cheapness also provides its own buffer zone, he says. When a stock is truly beaten up, it doesn’t have much room left to fall.

y Krishnan

atch Ultra Growth Fund

WITH STOCK INVESTING IN A BEAR market is no easy chore. But that's where Ajay Krishnan of Wasatch Ultra Growth Fund is paid to do. Krishnan seeks companies with solid earnings growth of at least 15%. Also, their businesses "fit into the overriding growth theme or competition trend." For instance, Accredo Health, a distributor of probiotic-based drugs, fits into the biotechnology revolution. "Most of the new drugs produced by biotech companies are protein-based," he says. "They cannot be distributed by drugstores because they must be refrigerated, and patients need special training to use them." Another theme is the need for small microchips: Monolithic System Technology and



Cabot Microelectronics make equipment to do that.

Krishnan assigns companies a "confidence rating" based on their likelihood of reaching his earnings targets. He's willing to pay more for "Future Stars"—stocks with high confidence levels—such as Accredo Health. He'll pay less for "Potential Stars"—telecom/tech companies Wireless Facilities and PDF Solutions—for which the forecast is less certain. He also buys stocks with lower growth estimates but a high probability of meeting them. Examples: Pediatrix Medical

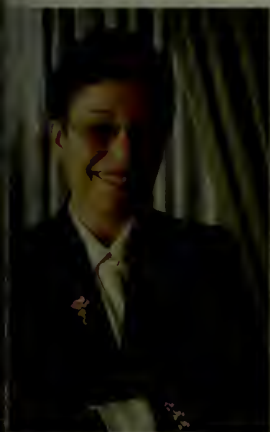
Group and AmSurg, medical service companies.

This valuation discipline keeps him from overpaying for stocks and helped him avoid the bear's claws in 2000 and 2001. Says Krishnan: "The biggest mistake people make isn't buying bad companies, but overpaying for good ones."

“The biggest mistake people make isn't buying bad companies but overpaying for good ones”

h Zell

erty Acorn International



LEAH ZELL SPECIALIZES in international investing, but her strategy is applicable in all markets. Her mutual fund, Liberty Acorn International, buys stocks of small and mid-size companies that dominate their industries. "The essence of a good company is one that has barriers to en-

try competitors," she says. "That gives us confidence that its earnings and cash flow are sustainable." One example: Intrawest, a Canadi-

an ski-resort operator with prime locations in British Columbia and Colorado. "The ski business is a tough one to break into, and these guys are pros at it," says Zell. "It takes a long time to build a resort, and environmental regulations are onerous."

Companies with good niches still need to be attractively priced. So Zell zooms in on price-to-cash-flow ratios as a check on value. Interest rates in the company's home country also come into play. The higher the rates, the less she'll pay for the stock.

Zell has 20 analysts scouring the globe for companies "that don't have a following on Wall Street." Usually, she favors small stocks, which she says are currently in "the sweet spot of the market." But occasionally she will buy a larger company such as Nintendo. "It's hard to find good companies in Japan," she says. "Nintendo has a huge slug of cash on its balance sheet and a dominant global franchise in electronic games."

“The essence of a good company is one that has barriers to entry to competitors”

p Datta

eric Investors Small Cap Value Fund

DATTA USES A COMPUTER TO PICK STOCKS for Numeric Investors Small Cap Value Fund, since he wants to be able to choose from a pool of 2,500 to 3,000 companies—and do it quickly.

First, Datta searches for companies with attractive valuations and positive earnings momentum. That means seeking stocks with low price-to-book and price-to-earnings ratios. But he doesn't demand rock bottom p-e's if the company has good growth prospects. And, he adds, he's looking for a short-term catalyst that will drive the stock up in the next six months. "That can be as simple as the company beating the earnings forecasts of Wall Street analysts. One example: Fresh Del Monte Produce, which has

topped estimates in each of the past five quarters.

Second, Datta employs an earnings-quality screen, looking for companies with cash flows significantly above their earnings, an indication that profits come from operations and not from accounting tricks. Since investors often value companies by earnings and not cash flow, the profit potential of such companies is often underappreciated. One such company: auto-parts supplier ArvinMeritor. Says Datta: "Cash flow at the company is huge."



“We're looking for a short-term catalyst that will drive the stock up in the next six months”

Why the Optimists May Be Right

The recovery is in better shape than the CEOs would have you believe

BY JAMES C. COOPER
AND
KATHLEEN MADIGAN

All year, investors and corporate chiefs have been at odds with economists. The former don't see a recovery and don't trust the future. The economists say the upturn is here, and the future looks good. Who's right? Federal Reserve Chairman Alan Greenspan has his money on the economists. He told bankers in Montreal on June 4 he felt that the dichotomy would be resolved by "the business community coming closer to the economists."

Let's hope he's right. Investors need some good news on the economy to offset a multitude of other worries. Corporate profits last year suffered one of their severest beatings in the postwar era. Now, terrorism and other geopolitical risks are also roiling the markets, not to mention CEO arrests and various government inquiries. "The post-Enron uncertainty surrounding corporate financial reporting and the tarnish on Corporate America have raised perceived risks in stocks," says economist Richard Berner at Morgan Stanley.

However, while investors may be pessimistic, Berner and others are sticking to their view of a lasting recovery and a profits rebound. Why? "Much of the uncertainty plaguing the financial markets is not associated with the underlying fundamentals of the economy," says Greg Mount of Bank One in Chicago. *BusinessWeek's* midyear survey of business economists shows that, on average, the forecasters expect real gross domestic product to grow at a healthy, if unspectacular, 3% annual rate during the second and third quarters, with the pace picking up to 3.5% in the first half of 2003 (table, page 112). Inflation will remain tame, they say, and the Fed will maintain its current, very stimulative policy into late summer or early autumn.

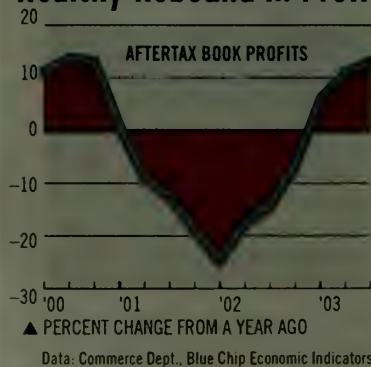


To be sure, economic growth will not repeat the first quarter's 5.6% gallop any time soon. Some of that gain resulted from a post-September 11 snapback as well as a sharp swing in inventories, and some was borrowed from the second quarter, reflecting stronger-than-usual demand during an exceptionally

winter. Those factors could slow second-quarter real growth to less than half the first quarter's pace.

But economic fundamentals point to healthier growth in the second half—a prospect investors appear to be overlooking. "The market has placed scant attention on compensating positive developments, such as renewed growth, strong product gains, a weaker currency, fiscal stimulus, and firming export demand," says Richard DeKaser of National

Economists Foresee a Healthy Rebound in Profits





constrained. So even in a mild recovery, any growth in top-line revenues will head straight to the bottom line.

Already, the trend can be seen in the data. The Commerce Dept.'s economywide measure of operating profits posted gains from the previous quarter in both the fourth and first quarters. And economists expect solid gains from a year ago by yearend (chart). Notes Bruce Steinberg at Merrill Lynch: "Operating earnings per share for the Standard and Poor's 500-stock index in the first quarter were up about 2% from a year ago, the first positive reading in a year and a half." He also points out that S&P profit margins widened sharply last quarter.

Economists are cautiously optimistic about future capital spending, as more profits are likely to spur it. Forward-looking indicators are already improving: First-quarter outlays for information-processing equipment posted their first rise in a year. April orders for nondefense capital goods, excluding aircraft, jumped sharply. And in May, output of both computers and semiconductors rose by double-digit rates compared with their year-ago levels.

But the capital-spending recovery will not have the vitality of the late-1990s boom because of current low factory operating rates, the capacity glut in telecom, and weak executive confidence. "If CEOs are benchmarking themselves against the profit levels of a few years

As companies continue to squeeze more productivity out of their workers and cut costs, the jobless rate isn't likely to fall—so the Fed probably won't lift rates

in Cleveland. Moreover, the Fed's post-September 11 rate cuts, totaling 175 basis points, are only now beginning to work through the economy. These pluses will keep consumer demand growing and generate the profits needed to spur capital spending and inventory rebuilding. Investors and economists are most sharply divided about the outlook for profits. Investors are taking their cues from dour CEOs, and in the current climate, corporate execs have every reason to be conservative. "The risk-reward payoff is such that being wrong on the conservative side will pay major dividends to the price, while being wrong on the optimistic side will be greatly penalized," says Joel L. Naroff of Naroff Economic Advisors. Plus, as Naroff noted in Montreal, the lack of pricing power means the recovery is not yet painting the most optimistic profits picture that CEOs like to see.

Economists' optimism on profits stems from exceptional productivity and restraint on labor costs in two decades. That's why profit margins are widening though pricing power is

back, then they may feel that business is still rather poor, and that could damp what would otherwise be a healthy pickup in capital spending," says Kevin Logan of Dresdner Kleinwort Wasserstein.

Financing problems won't hold back capital spending. By the first quarter, cash flow of non-financial corporations had recovered all of 2001's losses, with help from the government's new accelerated-depreciation allowances. Internally generated funds now cover nearly 90% of outlays for capital projects and inventories, up dramatically from last year. Also, sources of funds outside of the equity market are starting to open up. In contrast to stock investors, bond investors actually see less risk in lending to corporations, as shown by the smaller premium that corporations must pay on their bonds over riskless U.S. Treasuries. Even for the riskiest loans, "quality spreads in high-yield bonds, excluding telecom, have fallen, reflecting the improving economic outlook," says John E. Silvia of Wachovia Bank in Charlotte.

Financial conditions will continue to ease the

longer the Fed refrains from lifting interest rates—and economists keep pushing that date further into the future. The Fed has never tightened before the jobless rate starts to fall, so “the primary trigger for a retightening of policy will be clear signs of a recovery in the labor markets,” says Ethan Harris at Lehman Brothers. Given corporate efforts to lift productivity and cut costs, that will take a while.

But that doesn't mean consumers will bow out of the recovery. Job markets are already firming up, albeit gradually. And, while rapid productivity growth initially helps profits, especially at cutting-edge companies, consumers

benefit in the long run. “History demonstrates that the big winners overall will be wage earners, and therein lies the most durable source of a lasting expansion,” says Robert V. DiClemente at Salomon Smith Barney/Citicorp.

Productivity keeps inflation tame, even smaller gains in pay yield increased buying power.

Household income gains, an accommodative Fed, and signs of a recovery make it easy for economists to be optimistic about the outlook. Their hard job now is to convince investors and CEOs they're right.

With James Mehring in New York

MIDYEAR INVESTMENT GUIDE

BusinessWeek's Midyear Economic Forecast Survey for 2002-03

(ANNUAL RATE)	(ANNUAL RATE)	PERCENT CHANGE IN REAL GDP					PERCENT CHANGE IN CPI/FED FUNDS RATE				MONTH
		(END OF QUARTER)			FIRST FED	(ANNUAL RATE)		(END OF QUARTER)			
		2002	2003	2002		2003	2002	2003			
NAME	FIRM	II	III	IV	I	II	II	II	IV	II	FUNDS
WAYNE ANGELL	Angell Economics	3.2	3.2	3.5	3.7	4.0	2.4	1.2	1.75	2.25	Feb. 2
RICHARD BERNER	Morgan Stanley	2.6	4.1	4.3	3.8	3.9	2.7	3.0	2.75	4.00	Sept. 2
DAVID W. BERSON	Fannie Mae	3.1	3.5	3.5	4.1	4.1	2.3	2.2	3.00	4.25	Aug. 2
RICHARD DEKASER	National City	2.6	1.5	2.6	3.1	2.5	2.7	2.4	3.00	3.75	Aug. 2
ROBERT V. DICLEMENTE	Salomon Smith Barney/Citigroup	2.7	3.7	4.0	4.0	3.7	1.9	1.8	2.25	3.50	Nov. 2
WILLIAM DUNKELBERG	Natl. Fed. of Indep. Business	4.0	2.5	2.8	3.0	3.0	3.0	3.0	2.25	2.75	Aug. 2
GAIL FOSLER	The Conference Board	2.0	2.8	2.9	4.2	4.7	2.5	2.9	2.60	3.00	Aug. 2
ETHAN HARRIS	Lehman Brothers	2.5	3.0	4.0	4.0	3.5	1.6	2.7	2.50	3.50	Sept. 2
MAURY HARRIS	UBS Warburg	3.0	3.2	3.5	3.5	3.5	2.0	2.5	2.00	3.25	Nov. 2
KEVIN LOGAN	Dresdner Kleinwort Wasserstein	3.7	3.6	3.2	2.8	3.3	1.5	2.1	2.75	3.50	Aug. 2
JOHN LONSKI	Moody's Credit Trends	3.5	2.8	3.8	3.5	3.8	3.7	2.5	2.50	3.50	Sept. 2
CHRISTOPHER LOW	FTN Financial	3.0	2.5	3.5	4.0	4.5	2.2	2.0	1.75	3.00	Jan. 2
KEN MAYLAND	ClearView Economics	3.2	3.6	4.3	4.1	3.3	3.0	2.8	2.50	3.50	Sept. 2
GREG MOUNT	Bank One	3.1	3.9	4.5	3.2	3.5	2.1	2.3	3.75	4.25	Aug. 2
JOEL L. NAROFF	Naroff Economic Advisors	4.2	3.9	2.9	3.4	2.7	2.5	2.4	3.50	4.75	Aug. 2
MICHAEL P. NIEMIRA	Bank of Tokyo-Mitsubishi	1.9	2.8	3.8	3.0	3.3	2.7	2.9	2.50	3.25	Aug. 2
JAMES PAULSEN	Wells Capital Management	2.8	1.0	2.0	2.5	3.5	0.5	1.5	1.75	1.75	Aug. 2
JOHN POPE	Investment Economics	2.2	2.4	2.6	2.3	2.2	3.0	3.0	1.75	2.00	Apr. 2
DAVID RESLER	Nomura Securities Intl.	2.6	3.9	3.1	2.9	3.5	2.5	2.1	2.25	3.00	Nov. 2
RICHARD D. RIPPE	Prudential Securities	2.7	3.9	4.3	4.2	4.0	2.6	2.5	2.75	3.50	Aug. 2
JOHN E. SILVIA	Wachovia	3.3	3.0	3.9	3.9	4.7	2.8	3.2	2.50	3.50	Sept. 2
ALLEN SINAI	Decision Economics	2.8	2.5	3.3	4.0	3.2	2.1	2.5	2.25	2.75	Sept. 2
BRUCE STEINBERG	Merrill Lynch	4.0	4.5	4.5	4.1	4.2	1.0	1.6	2.75	3.50	Aug. 2
STEVEN WOOD	Financial Oxygen	3.0	2.6	2.8	3.2	2.9	2.4	2.5	2.50	4.00	Sept. 2
DAVID WYSS	Standard & Poor's	3.8	2.9	5.0	5.0	4.6	3.1	2.9	2.50	3.50	Sept. 2
RICHARD YAMARONE	Argus Research	3.1	2.3	2.7	2.3	1.9	3.5	4.0	3.00	4.25	Aug. 2
MARK ZANDI	Economy.com	2.7	2.4	3.0	4.0	4.4	2.5	2.3	2.50	3.75	Sept. 2
CONSENSUS		3.0%	3.0%	3.5%	3.5%	3.6%	2.4%	2.5%	2.5%	3.4%	SEPT. 2

I love dissecting humans.

Eileen Cuesta

LIBERTY MUTUAL FIELD INVESTIGATOR



BUSINESS



AUTO



HOME



LIFE

// It's my job to be an excellent judge of character...to determine when someone is telling the truth and when they're committing insurance fraud. Of course, most people are honest, but the ones that aren't cost businesses and workers \$25 billion a year. That's why I'm available at a moment's notice to throw my gear in the trunk and discover the truth. I talk to witnesses, follow tire tracks down muddy roads...whatever it takes to make sure the good guys, and the bad ones, get exactly what they deserve. //



IT'S MORE THAN INSURANCE, IT'S INSURANCE IN ACTION.

Consider forming an in-house safety team in order to evaluate and record accidents as they happen. Also, report accidents immediately to insure accuracy.



Liberty
Mutual.

Mapping The Minefield

Since the first stock market opened, one question has always been foremost in investors' minds: How can I make money? That, of course, was a cinch during the most recent, two-decade-long bull market. Simply tossing money into an index fund was sufficient to net investors huge gains. No longer. In today's choppy markets, picking the right stocks is imperative.

BusinessWeek has put together a map to help you steer through the market's minefields to those companies with potential for gains. A few stocks in the technology, health-care, specialty retail, financial services, and energy sectors pass muster, as do some foreign companies and U.S.-based multinationals. Time and again, we look for uncomplicated companies with strong balance sheets that sell for less than their peers—and mutual funds run by managers who choose similar stocks—as the most promising way to come out ahead.

TECHNOLOGY

There are pockets of opportunity for the brave

BY GEOFFREY SMITH

Thinking about trying to pick some bargain tech stocks because the Nasdaq has dropped 23% this year? Don't kid yourself. Most shares are still expensive, at times Wall Street's estimated earnings over the next 12 months—and the sum of profits don't fall more than what they already have. Plus, corporate spending—the lifeblood of the sector—is still in the tank going into the second half. "It's just patently obvious there are not a lot of earnings to support these [stocks]," says Scott E. Wittenberg, who manages \$1.6 billion at Dreyfus Management in Boston. "You've got to take a leap of faith to buy them."

That's not stopping investors from jumping in. Some money managers are playing it safe by owning only the healthiest of the tech elite, including Microsoft and Dell Computer. Others are buying companies that are finding ways to boost sales, such as

Nothing seems to dampen demand for video games—and recent price cuts on consoles will only add to it

has been gaining business as cost-conscious U.S. companies outsource their chip manufacturing to foreign suppliers, according to Gail Seneca, manager of Phoenix-Seneca Growth Fund. At a recent price of \$14 on the Big Board, it sold at 38 times estimated 2002 profits. But Seneca says the multiple is only 18.5 based on her estimated profits in 2003, and her estimates "have only been going up."

Another play in chips is Peak International in Fremont, Calif. This tiny company supplies Asian chipmakers with packaging equipment. Revenues plummeted in its fiscal year ended Mar. 31, to \$45 million from \$86 million, following the chip industry's swoon. But Delphi Management's Black, a veteran value investor, says its order rates are improving as business picks up at Asian chip companies. At \$7.21 a share, it's one of only a handful of tech stocks so cheap that, like AMD, it trades at book value.

The networking sector has been among the hardest hit. But strong balance sheets are key, says Mark Donovan, co-chief of equity strategy at Boston Partners Asset Management. That's why he owns 3Com. Sales were down 50% over the past nine months, and the company has steep losses. But at a recent price of \$4.85 a share, 3Com trades close to the \$4 a share in net cash it has on the books. "We're less willing to go out on the risk curve on a company like [heavily indebted] Nortel Networks when 3Com has the stronger balance sheet," Donovan says.

Throughout the tech downturn, consumers have continued to buy digital cameras and DVD players at a healthy clip, and sales are expected to remain robust. That's why Christopher Ely, a manager of small-cap stocks at Loomis Sayles, likes Zoran, which makes chips for those products. Sales climbed 59% in the first quarter, to \$31 million, and Wall Street forecasts a 138% earnings jump for this year. Ely believes Zoran's valuation of 32 times estimated 2002 profits is reasonable since he expects

**MIDYEAR
INVESTMENT
GUIDE**

Taking a Chance on Tech

COMPANY/SYMBOL	PRICE*	P-E**	COMMENTS
ADVANCED MICRO DEVICES AMD	\$9.60	NA	Chipmaker's new 64-bit processor could be worth a double in the stock
ELI TRONIC ARTS	62.31	35†	The video-game maker benefits from the popular Xbox and GameCube
PEAK INTERNATIONAL	7.21	NA	Recovery under way at this tiny supplier of packaging for chips
3COM	4.85	NA	Healthy balance sheet gives it an edge over debt-laden rivals
ZORAN	19.71	32	Makes chips for hot products such as DVD players and digital cameras

*Based on estimated 2002 earnings †Fiscal year ends Mar., 2003 Data: *BusinessWeek*, Bloomberg Financial Markets

earnings to rise 50% more next year.

Following the hot consumer-technology products, Ely is also investing in gamemaker Electronic Arts. He expects the company to see a surge in video-game sales extended into 2003, fueled in part by recent price cuts in video-game consoles. At a recent price of \$62.31 a share, Electronic Arts traded at 35

times Wall Street's estimated profits of \$1.73 a share for the fiscal year ending next March. But Ely thinks profits could grow 30% next year.

Many investors aren't willing to make such long-range forecasts the basis of their tech bets. Instead, they're watching for a pickup in corporate tech spending. "I don't think earnings prospects

for technology are well enough deep to sustain a rally now, but in a few months, that could change," says Floyd, a senior analyst at Leu Group, a Minneapolis stock market researcher. In the meantime, investors should reject the notion that tech stocks will ever again perform as they did in the 1990s.

HEALTH CARE

In a turnabout, now it's hospitals and HMOs that look robust

BY AMY BARRETT

Product companies out. Service companies in. That's the prescription for health-care investing these days. It also reverses a long-term trend. Until recently, stocks of biotech, drug, and medical-device companies sold like crazy, reflecting patient demand for the latest treatments, no matter how costly. That was bad news for hospitals and insurers—investors shunned those stocks. Now, HMOs and hospitals are on the rebound, sticking double-digit price increases to their customers, many of them large companies that offer their staff medical insurance.

Meantime, pharmaceutical and biotech product pipelines are drying up, making blockbuster treatments less likely anytime soon. Aside from a few out-of-favor but promising drug stocks, "the services stocks will continue to outperform product-based companies," says Jon M. Fisher, head of equity research at Fifth Third Bank in Cincinnati. Demographics support that trend. Norman M. Fidel, health-care portfolio manager at Alliance Capital Management, says an aging population should drive hospital admissions as insurance reimbursement rates rise—in some cases by nearly 10%.

Fidel likes rural hospital operator Health Management Associates, based in Naples, Fla. Alliance held almost 30 million shares of HMA as of Mar. 31. It has a reputation for quality care and a low debt-to-capital ratio. The company could benefit from efforts in Congress to boost Medicare reimbursement for rural hospitals. Analysts say the stock is relatively cheap at a price-earn-

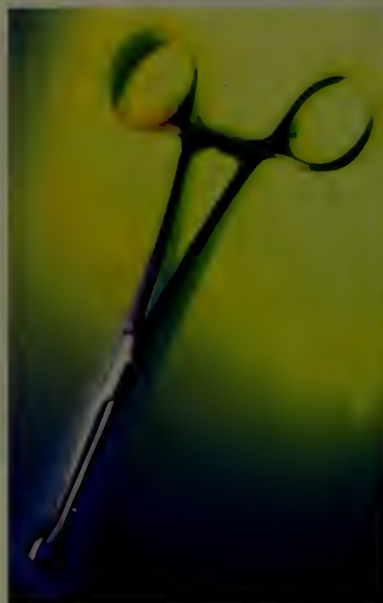
ings ratio of 18.6 based on expected 2003 earnings. "The fundamentals [for hospitals] are the best in 15 to 20 years," says Fidel.

Managed-care companies and insurers also have the wind at their backs. Fifth Third's Fisher likes Anthem, a BlueCross BlueShield operator that recently went public. He figures the company can boost margins and make some acquisitions. He also sees Anthem as cheap at about 16 times projected 2003 earnings.

He figures its p-e should be least 18.

There are also ways to profit from big drugmakers' pain. According to SG Cowen Securities, from 2002 to 2005, drugs with \$30 billion in U.S. sales will lose patent protection or other forms of market exclusivity—great news for generic drugmakers.

Jon D. Stephenson, an analyst at State Street Research & Management,



likes generic drugmaker Barr Laboratories. The company is focused on products that attract few generics. For example, oral contraceptives haven't lured many generic players because it's difficult to obtain the raw materials and manufacture the pills. But by 2030, the end of its patent life, Barr expects to offer nine oral contraceptives. The company trades at 14 times 2003 earnings estimates—vs. about 25 for the industry.

CIBC World Markets analyst I. Wilbur believes Barr's 2003 p-e should be about 25.

Of course, some branded drugs continue to grow at a healthy clip, especially biotech-based drugs which, for regulatory and manufacturing reasons, attracted few generic competitors. Pharmaceutical company Baxter International is on a tear thanks to a product for hemophiliacs called Recombinase. Merrill Lynch analyst Daniel T. Lenz

thinks it will produce some 40% of Baxter's earnings growth in the next few years. Although earnings growth will hit high teens in that period, Baxter's p-e based on 2003 projected earnings, is just 23. Lemaitre thinks should be well over 30. "This is a product that will transform the company," he argues. And possibly the folios of some investors.

MIDYEAR INVESTMENT GUIDE

Health Stocks in the Pink

COMPANY/SYMBOL	PRICE*	P-E**	COMMENTS
ANTHEM ATH	\$71.39	19	An ex-BlueCross/BlueShield company that could earn better margins
BARR LABORATORIES BRL	64.86	13	New generics, including oral contraceptives, could drive the stock
BAXTER INTERNATIONAL BAX	46.46	24	Has a fast-growing hemophilia product
HEALTH MANAGEMENT ASSOCIATES HMA	21.59	23	A rural hospital chain benefiting from higher Medicare reimbursements

*June 14

**Based on estimated 2002 earnings

Data: BusinessWeek, Bloomberg Financial Markets

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ENERGY Because of the Enron Effect, some gas and electric companies have become bargains

BY CHRISTOPHER PALMERI

When the world is in turmoil, investors often retreat to Big Oil stocks. But with crude prices—infused by war fears—rising about 25% this year, to \$25 a barrel, fast-growing natural gas producers and electric utilities caught in the post-Enron downdraft may be safer plays right now.

U.S. demand for natural gas has been growing, thanks to a surge in power-plant construction. But supply has been lagging. That's why Devon Energy in Oklahoma City, which has been buying up exploration and production companies, is the top pick of Richard Giesen, manager of the \$134 million Munder Power Plus Fund.

If natural gas prices—now at \$3.30 per 1,000 cubic feet—remain strong, Devon could be a big winner. Some 70% of its production is natural gas, and growth in that area is expected to proceed at 4% to 5% a year for the foreseeable future. In the meantime, the purchases of such companies as Mitchell Energy & Development and Anderson Exploration have extended Devon's debt to about 60% of capi-

tal. As a result, Devon trades at about five times cash flow, vs. six for rival outfits. The company is reducing debt by selling noncore properties in such places as Indonesia and Argentina.

Another attractive stock is EnCana, a Calgary-based company formed earlier this year through the combination of PanCanadian Energy and Alberta Energy. Robert Shearer, manager of the \$119 million Merrill Lynch Natural Resources Fund, says EnCana has some of the strongest projected production growth in the industry but trades at the same cash flow multiple as slower-growing U.S. peers.

Drilling for Returns

COMPANY/SYMBOL	PRICE*	P-E**	COMMENT
AMERADA HESS AHC	\$77.77	11	Restructuring has created a more focused exploration company
DEVON ENERGY DVN	47.55	17	Aggressive natural gas producer has sold assets to reduce debt
ENCANA ECA	29.70	21	Newly formed Canadian company with growing oil and gas interests
FPL GROUP FPL	59.75	13	Midsize utility expanding its U.S. power plant portfolio
TXU TXU	51.27	12	Utility has been reducing debt to shore up its global business

*June 14

**Based on estimated 2002 earnings
Data: BusinessWeek, Bloomberg Financial Markets

Among the company's most promising projects is the Deep Panuke off the coast of Nova Scotia. EnCana is sinking about \$1.1 billion into this, which contains an estimated one cubic feet of natural gas. It will be supplying Northeastern markets in 2005. Thanks to Deep Panuke and other projects, Shearer figures EnCana will see 12% per year production growth over the next three years.

Concern about Enron-like meltdowns has knocked down share prices of conservatively run electric and gas utilities, says Eaton Vance Utility Fund manager Judith Saryan. The fund's top holdings are TXU and EnCana Group. Dallas-based TXU—with \$10 billion in sales and about 11 million electric and gas customers in the U.S., Europe, and Australia—has been selling assets to reduce its debt. Expanding its electricity business into such newly opened markets as China and Germany, it expects earnings to grow about 10% a year for the next few years.

Juno Beach (Fla.)-based FPL is a smaller operation, best known as the parent of Florida Power and Light. Like TXU, it has been moving into markets outside of its traditional territory. FPL recently announced plans to take a majority stake in the Sea Mar nuclear power plant in New Hampshire and said it was on track to increase earnings 7% a year through 2005.

One member of the Big Oil family that could do well even if oil prices decline is Amerada Hess. Since taking the reins at this \$13 billion oil refraction and refining company in 1998 from his father, Leon Hess, CEO of Hess has made a strong effort to improve returns. He sold a half-interest

in the company's massive Trinidad Islands refinery, and has doubled the number of refining stations it owns on the East Coast, and acquired Triton Energy, an exploration company promising discoveries in the West African coast. The company has increased its cash flow three times this year, and its anticipated cash flow, it is much cheaper than its peers, according to FPL's Gillon, an oil company analyst at John S. Her-

With both the global oil business and the U.S. electric market in turmoil, energy stocks are likely to be volatile. But there is opportunity.

SPECIALTY RETAIL

Select group of niche
retailers is looking spiffy

BERT BERNER

Attention, bargain stock shoppers. Before you give up completely on the sagging retail sector, take some time to poke through the racks in a few specialty clothing stores. At a time when the big chains are already exhausted the pop they get early in a recovery, the guys are outperforming them. No big mystery why: Discretionary spending, which the specialty depends on far more than big do, tends to catch fire late in a recovery. As a result, the Standard & Poor's specialty-apparel index is up for the year, while the S&P's broad index is down 5.2%.

It's important to be selective. The sector, like its underlying business, is volatile. But the best niche players should continue to do especially the smaller companies. They're benefiting from the woes of the big up, the largest of the specialty stores. Its comparable-store sales have risen for 25 straight months, allowing smaller players to steal market share. Besides, a modest improvement in dollar sales at a small company can produce a bigger earnings jump than it can for the big players.

That's why institutional investors like Abercrombie & Fitch as a strong term play, even though its share price has bounced around wildly between \$46 and \$8 in the past two years. It's now trading at \$25.50. Even with sales down at stores that have been open at least a year, Abercrombie's first-quarter profits rose 13%, thanks to tight inventory and expense discipline. With that discipline, Dreyfus Elaine Rees expects pleasant surprises from Abercrombie's earnings as teens start loading up on the company's popular surfer-style gear. "When the sales turn, there



Bargains on the Specialty Racks

COMPANY/SYMBOL	PRICE*	P/E**	COMMENT
ABERCROMBIE & FITCH ANF	\$25.50	14	Tighter expense controls make upside earnings surprises likely
AMERICAN EAGLE OUTFITTERS AEOS	21.18	14	The teen retailer is veering back to the peasant styles that made it a hit before
CHICO'S FASHIONS CHS	39.18	28	Earnings are growing faster than at most of its rivals
J. JILL *** JILL	35.10	26	Originally a mail-order business, it's successfully opening stores
TALBOTS TLB	37.40	18	Sales are rebounding after the classic clothing chain bet too much on suits

*June 14 **Estimated earnings, fiscal year ending Jan., 2003 ***Calendar year Data: BusinessWeek, Bloomberg Financial Mkts.

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Ask THE Experts



Bill Maurer

is a Vice President and Research Director in the Strategic Sourcing Group at Stamford, Conn., based Gartner, one of the world's leading IT research consultancies. He specializes in studying IT outsourcing issues as they pertain to the enterprise. We asked Mr. Maurer to explain the new distributed IT infrastructure model and the benefits it offers to today's business enterprises.

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Topic: DISTRIBUTED IT INFRASTRUCTURE

Q. What is a distributed IT infrastructure, and why is it important to the enterprise?

Gartner defines a "distributed computing infrastructure" as being comprised of desktop computers, servers, the underlying network infrastructure, and the processes and organization that support this environment. This support environment generally includes such items as help desk, mobile, desk side support services, remote server support services, IT asset management, backup and recovery processes, hardware standards establishment, and many other related functions. The importance of this set of services should be clear from the fact that it touches all phases of enterprise operational activity.

Q. What are the options an enterprise faces in outsourcing its IT infrastructure?

As enterprises become more dependent on outsourcers, they face the decision to build a sourcing strategy around a single, external source or multiple integrated sources. The decision can profoundly affect the enterprise's operational capabilities, yet is often made without recognizing the internal factors driving the decision. For instance, a single-source approach can work well for enterprises that can manage a single, complex contract, but that lack the capa-

bility to manage and integrate multiple suppliers. On the other hand, as an enterprise's understanding of multiple suppliers increases, and as its ability to manage and integrate these suppliers matures, a prime or general contractor approach can be beneficial in that it enables the enterprise to obtain a mix of suppliers without the burden of managing the suppliers directly. Enterprises with strong supplier management and integration capabilities can benefit from a best-of-breed approach, which works best in organizations that have invested in developing sourcing competencies.

Q. Is the benefit of outsourcing a distributed IT infrastructure purely cost-related, or are there other benefits?

Cost savings are not the only, or even the main, advantage of IT outsourcing. In fact, outsourcing may not cost less than in-house solutions. Gartner research notes tell enterprises that if they are outsourcing only to reduce costs, they should not do so, because cost reductions may not result. Rather, the real reason to outsource is because an enterprise has determined that building and maintaining an IT infrastructure is not a core competency its leaders want to cultivate. Outsourcing programs therefore should not be designed to reduce costs (although this may

be a beneficial result) assist the enterprise in meeting its business objectives.

Q. What characteristics of enterprises seeking to source their distributed infrastructure look for in a service provider?

There are five primary characteristics that an enterprise should consider when evaluating an outsourcer. What is the provider's process, technical experience, and industry experience, and how do they align with the enterprise's internal expertise and the enterprise's requirements? What is the provider's track record in forming like kind and repeat work? Is the outsourcer willing to entertain the type of contract that is appropriate for the specific engagement? Which specific personnel is the outsourcer planning to dedicate to the effort, and how willing is the outsourcer to commit those individuals? Finally, how well aligned are the outsourcer's organizations culturally? The last point is particularly important in highly strategic or long-term relationships.

Carefully examining these characteristics ahead of time will ensure a more satisfactory distributed outsourcing relationship.

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is a lot of money to be made," says Rees.

Timing is everything with specialty retailers, because they fall in and out of favor quickly. American Eagle Outfitters, for example, is paying the penalty for its fashion faux pas in the first half of the year, when it missed the bohemian and peasant styles. Second-quarter profits are expected to be down, continuing a fall that started late last year. But American Eagle is now picking up on the folksy styles, which could pay off in the second half. Lazard Frères analyst Todd Slater expects second-half earnings to be up 20% year-on-year, after falling an estimated 13% in the first half. Now priced at about \$22 a share, "this will be a \$30 stock by yearend," he says.

Another promising second-half prospect, say analysts, is Talbots, the classic women's clothing retailer. Through spring, it bet too heavily on structured clothing, such as suits, when women wanted less fitted items. But Talbots' management is considered among the best in retail, and many analysts expect the company to get back on track for the remainder of the year, when its mix typically includes more casual clothing. May sales fell only 3%, when most analysts braced for a decline near the mid-teens. Talbots says virtually all merchandise sold at regular prices.

Two small casual chains, Chico's FAS in Fort Myers, Fla., and J. Jill Group in Quincy, Mass., offer some of best growth prospects in the sector. Analysts expect earnings-per-share gains of 42% and 30%, respectively, in their current fiscal years. Both sell casual clothes targeting women 35 and older. Although they have had good runs this year, they're still trading at lower price-earnings ratios than many fast-growing retailers.

Even slightly better-than-expected earnings could drive shares higher. J. Jill could post the biggest near-term gain, argues Jeffrey Klinefelter, an analyst at U.S. Bancorp Piper Jaffray. With 55 stores, vs. Chico's 319, "they are just at the start of their growth curve."

Despite the perpetual worries that consumers will sit on their wallets, they're still spending. But investors, like fashionistas, are always a season ahead of the economy. And they've already gotten a fair bit of wear out of the specialty-sector play. Still, there could be some finds left for picky shoppers.

FINANCIAL SERVICES

A little investor fortitude may go a long, long way

BY HEATHER TIMMONS

Seems unlikely that there would be many buys among financial stocks, given recent scandals involving brokerages and the miserable business climate for investment banks. The Standard & Poor's 500 Diversified Financial Index, which includes a range of banks, brokerages, and finance companies, has fallen 17% in the last 12 months.

But investors with iron nerves can still find potential long-term winners among the most downtrodden of the banks and brokers—as well as some more immediate gratification from regional banks that don't have much exposure to Wall Street's woes.

Some financials now look dirt-cheap. Thomson First Call expects their earnings to rise 30% this year, lead by a doubling of insurers' earnings.

The top pick of many money managers is Prudential Financial. The property-casualty insurer and brokerage firm's stock has gained about 23% since it went public in December, 2001. Even so, Prudential's current \$20 billion market value is just over its book value. Also, the company could soon join the Standard & Poor's 500-stock index,



following MetLife. John Hancock Financial Services, were each added to the index less than a month after they went public. Schutz, portfolio manager of the Buyout Financial Services fund, notes that after a stock named to the index, it typically jumps 5%, as funds scramble to get it to their portfolios. Schutz also expects Prudential to back stock, because

has "way too much" capital.

The riskiest bets are brokerage bear market and New York State General Eliot Spitzer's campaign against equity analysts who issued rosy research to win banking deals. Billions of dollars from their mark-ups. Merrill Lynch, though it was Spitzer's first target, is a favorite pick of analysts. The stock is down 25% since the start of the year, and could go lower if the company loses costly class actions. But it remains one of Wall Street's strongest and could rebound once the market turns up. "If the economy recovers, the brokerage sector is where you can make more money," Schutz says.

FleetBoston Financial, too, has been in the doldrums since recording a \$500 million loss in the fourth quarter because of venture-capital write-downs and

MIDYEAR INVESTMENT GUIDE

Financial Fancies

COMPANY/SYMBOL	PRICE*	P/E**	COMMENTS
COMPASS BANCSHARES CBSS	\$32.97	14	In a risky environment, this Alabama-based regional bank looks good
FLEETBOSTON FINANCIAL FBF	33.08	12	Asset sales could improve the diversified financial outfit's prospects
MERRILL LYNCH MER	39.00	14	America's biggest broker looks cheap after revelations of shoddy research practices
PRUDENTIAL FINANCIAL PRU	33.94	15	Financial-services giant could get a boost if it joins the S&P 500

*June 14

**Based on estimated 2002 earnings

Data: BusinessWeek, Bloomberg Financial Markets

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gentina exposure. On June 6, Fitch, the rating agency, downgraded its credit outlook from stable to negative. Even so, some wonder if the bank's stock isn't finally worth betting on. Michael Mayo, Prudential Securities' notoriously bearish bank analyst, recently upgraded it to a sell from a hold. He says the company's strategy of selling its investment-banking unit and concentrating on safer havens such as retail banking and small-business lending makes sense. Still, Fleet

will be no bargain if it records more losses from Argentina.

For those with less stomach for risk, there are midcap banks that focus on local businesses and have little overseas exposure. Michael Corasaniti, director of research at broker Keefe, Bruyette & Woods, recommends Compass Bancshares, a Birmingham (Ala.) bank with \$23 billion in assets. What's so special about Compass?

Nothing, says Corasaniti—and the way he likes it. "It's really basic banking," he says. "That's the

theme for the rest of the year: keep it boring and simple."

Financial companies are at the heart of the crisis in Corporate America and the markets. And they're

going to go away quickly. But for investors willing to take big risks on beaten-down stocks, there could be a payoff.

MIDYEAR INVESTMENT GUIDE

MEDIA

Investors are testing the wind for a return of ad sales

BY RONALD GROVER

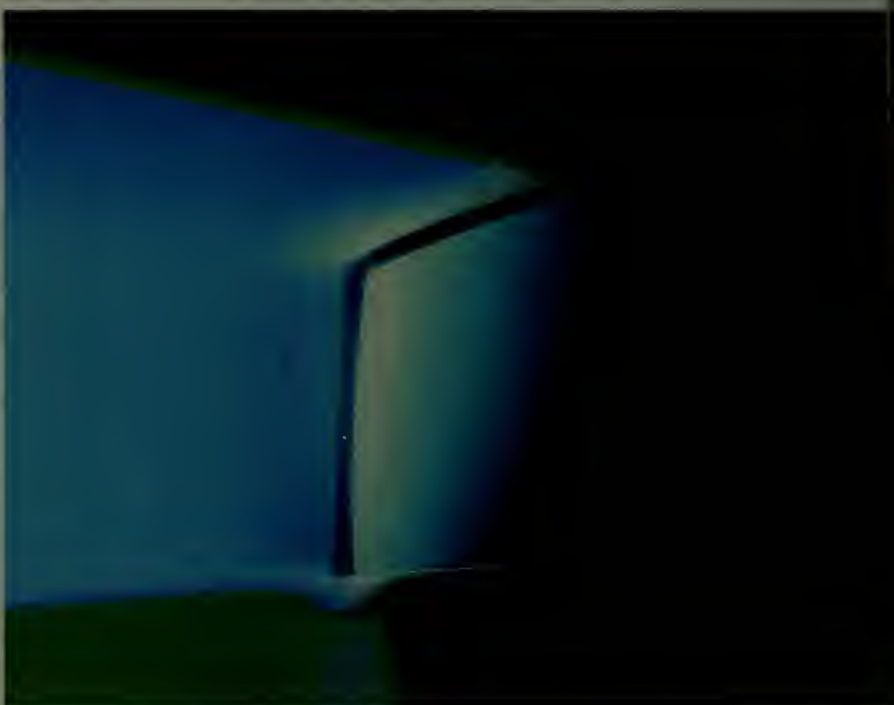
As the spring TV season ends, media investors are grappling with their own cliffhanger. The question on their minds: When will ad sales return? Some are taking heart from the \$8 billion racked up by TV networks for the September season, a 16% hike from the year before. That brings their up-front ad sales to where they were in 2000. Some of those commitments could yet be withdrawn. Still, the gain is enough to start investors thinking about a revival in media stocks, a sector that has been trailing the Standard & Poor's 500-stock index most of this year.

Investors are already moving to companies such as Viacom and News Corp. There's even interest in such beaten-down players as AOL Time Warner and Walt Disney. Some are also betting on John Malone's Liberty Media.

Basu Mullick, a portfolio manager of the Neuberger Berman Partners Fund, recently bought both Viacom and Disney. Mullick likes Viacom's cost-conscious management and hot shows such as *The Osbournes* on its MTV network. His rationale for buying Disney is completely different. He reckons market sentiment is so negative on the company that any ad upturn should buoy the stock. Disney also has hinted that advance theme-park bookings for this summer have firmed.

News Corp.'s globe-girding collection of assets make it, at \$26, "the cheapest media company out there," says Ajay Mehra, a portfolio manager with Columbia Management Group. He says News Corp.'s cash flow could grow by 20% or more this year. The one wild card is Chairman Rupert Murdoch's penchant for the big deal, which in the past has hobbled the company with debt.

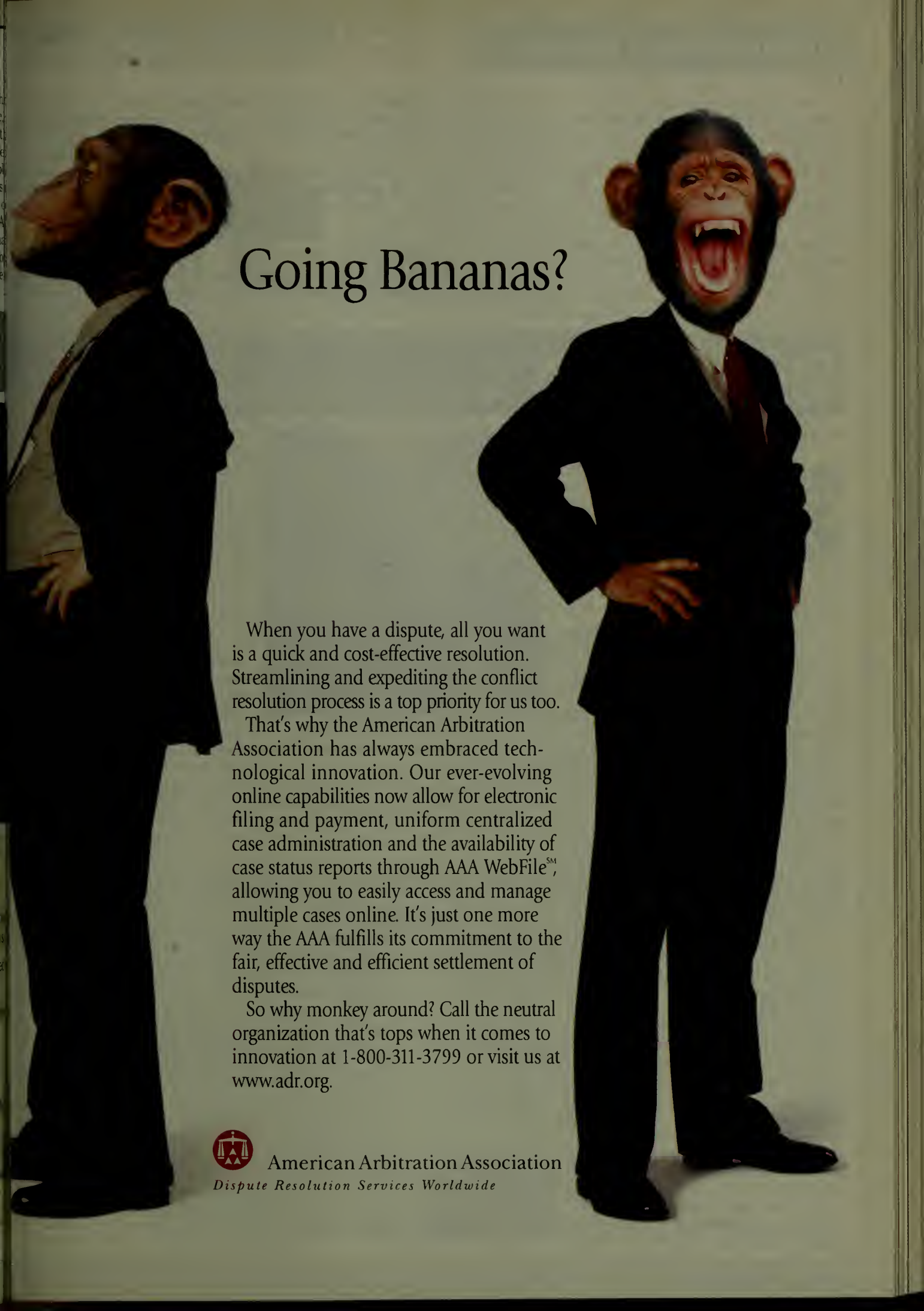
Perhaps a purer entertainment play is News Corp.'s 85%-owned Fox Enter-



Upbeat Media Scenarios

COMPANY/SYMBOL	PRICE*	P/E RATIO**	COMMENT
AOL TIME WARNER AOL	\$16.40	18	No turnaround yet, but the stock could get a boost if the company resolves management and other issues
COMCAST CMCSK	26.89	36	A sharp operator in a beaten-down cable-TV sector, nearing its bottom
LIBERTY MEDIA L	10.19	NA	Its assets, such as cable channels Discovery and MTV, are undervalued by the market
NEWS CORP*** NWS	25.58	45	Tight cost controls help cash flow, but some hits at Fox network would be nice
SPANISH BROADCASTING SYSTEM SBSA	12.10	143	Spanish radio station owner could be a target for NBC's Telemundo
VIACOM VIA	44.92	38	Rebounding ad market and hit shows on MTV and CBS already have buoyed its stock

*June 14 **Based on estimated 2002 earnings ***June 30 fiscal year Data: BusinessWeek, Bloomberg Financial



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tainment Group, says Merrill Lynch's Jessica Reif Cohen. She likes the cash flow from Fox's 33-station TV group and its string of recent hit films such as *Ice Age*. She also upgraded AOL Time Warner from "neutral" to "buy," with a 12-month target of \$25. That 58% boost assumes resolution of several issues, including negotiations to withdraw from ventures with Comcast and Newhouse.

Like AOL, Liberty Media is in the dumps but has its fans. Christopher Dixon of UBS Warburg says investors

dislike Liberty's complexity. That's why the stock is at a 52-week low of \$10.35. Dixon gives it a "strong buy," saying assets like the QVC channel come to \$17 a share.

Some investors are weighing a return to the cable-TV sector, which has been battered by disclosures of self-dealings at Adelphia Communications. Columbia's Mehra recently bought a million Comcast shares, drawn by the efficiencies it can wring from its pend-

ing merger with AT&T's cable. There's merger potential among players, too. Easier rules for TV ownership can make targets such as Gray Communications, says fund manager Gabelli. After Univision's billion bid for Hispanic Broadcasting, tiny Spanish Broad-System, with 25 radio stations, may be the radar of NBC's Telemundo, which adds suspense to the new se-

MIDYEAR INVESTMENT GUIDE

GLOBAL STOCKS

ADRs get you a piece of promising foreign plays

BY LEWIS BRAHAM

Some of the brightest spots in today's dreary investment climate lie beyond our borders, but they're not out of reach. Stocks of some 2,200 foreign companies trade in the U.S., either directly, as with Canadian shares, or as American depositary receipts. ADRs are bank-created financial instruments that represent ownership in a foreign company. Either way, the trading is in U.S. dollars, with U.S. stock symbols and through domestic brokerages.

Global investors say the best opportunities are in small-to-midsize companies with market caps below \$10 billion. One in that range is Irish airline Ryanair. Its ADRs on Nasdaq have taken off. "This company has cloned Southwest Airlines' business model in Europe, and it has been fantastically successful," says Svein Backer, a portfolio manager at Driehaus International Growth Fund. "The goal is to offer travel 40% cheaper than competitors and use secondary airports instead of hubs."

Even with the drop in air travel last fall, Ryanair enjoyed 30% growth in passengers and 27% growth in earnings for 2001. Analysts expect earnings to grow 21.5% per year over the next five years. True, with a price-earnings ratio of 27 based on estimated profits for the fiscal year ending Mar. 31, 2003, it's not cheap, but good growth companies rarely are.

You can also make money in a consolidating industry. That's the lure



of small-to-midsize Canadian oil companies, says Richard Pell, who runs Julius Baer International Equity Fund. He thinks major oil companies in search of replacements for declining reserves could acquire such businesses. Pell's top pick: Canadian Natural Resources, that nation's

second-largest gas producer. It sells p-e, about the cheapest of the Canadian exploration and production companies.

Bargains may still be found in emerging markets, even though they've been a roll. Value investor John Speer Tweedy Browne Global Value Fund owns Mexico's PanAmerican Beverage, the largest soft-drink bottler in Latin America. Although much of its business is from selling Coca-Cola, it trades at a p-e of 14, while Coca-Cola trades at 22. Another emerging opportunity is China Mobile, China's largest cell-phone provider. "China has a huge potential market for cell phones, since land line traditional phones are scarce," says portfolio manager Gary Bergstrom of AQR Asset management. Last year, the company had a 54% jump in subscribers to 69.6 million, and a 55% increase in revenue. It has a 2002 p-e of only 15.

If you prefer blue chips, Chris Wolfe, equity strategist at J.P. Morgan

private bank, recommends Swiss pharmaceutical giant Novartis. Novartis' p-e is a modest 22, down from an expected 2002 high of 31. That's nearly below the 31 p-e of the drug industry. The company has suffered from sluggish revenue growth. Wolfe says upcoming launches of new drugs to treat eczema, arthritis, asthma, and bone cancer should boost sales.

Those diseases have no borders, and people won't care which country relief comes from. Investors with ailing portfolios might take the same attitude.

Global Investing Without Leaving Home

COMPANY/SYMBOL	PRICE*	P-E RATIO**	COMMENTS
CANADIAN NATURAL RESOURCES CED	\$31.44	12	Canada's No. 2 gas producer is a potential takeover target
CHINA MOBILE CHL	15.17	15	China's largest cell-phone service provider has a growing subscriber base
NOVARTIS NVS	38.67	22	The Swiss pharmaceutical giant has been ailing of late, but its new-drug pipeline should cure it
PANAMERICAN BEVERAGES PB	16.80	14	This Mexican soft-drink bottler has a low valuation—and management that is motivated to perk it up
RYANAIR*** RYAA	35.00	27	Rapidly growing Irish airline specializes in discounted fares

*June 14

**Based on estimated 2002 earnings.

***Fiscal year ending Mar. 31, 2003

Data: BusinessWeek, Bloomberg Financial Markets

Active Managers Flex Their Muscles

Indexes fall, the hard work of finding good companies is being rewarded

ARA DER
NESIAN

Active managers of U.S. stock mutual funds have wrestled with a directionless market and an anemic economy. They've contended with earnings shortfalls and warnings of terrorist attacks. And for all that, they have managed to limit losses to 10% on average so far this year. That isn't going to pull investors out of their funk, but it's enough to beat the market through June 14. The Standard & Poor's 500-stock index was down 12.3%, while the Dow Jones industrial average was off 5.5%. The Nasdaq Composite Index has lost 23%, with no end to tech stocks' downward spiral in sight.

Stock-pickers have waited a long time to strut their stuff. Many got the brush-off from investors during the 1990s, when all it took to make big money was to buy an index or tech-sector fund. The low-cost, \$69 billion Vanguard 500 Index Fund, for instance, quintupled in value in the 1990s, reaping gains of 17.4% a year. But with the start of the bear market in March, 2000, the pick-and-shovel work of mining for underappreciated companies with clean balance sheets and solid prospects began in earnest.

The excavation work has paid off handsomely for the most conservative value investors, and that will likely continue through the year and beyond. The best managers of sector funds—from real estate to financial stocks—have been rewarded for their tempered style. Still, nobody is taking their edge for granted: "There's no room for error," says value manager Steven J. Lehman, of the \$258 million Federated

Market Opportunity Fund, a multicap fund that's heavily weighted in mid-cap stocks. Lehman's 85-stock portfolio, which includes agribusiness giant Bunge Limited and Potomac Electric Power Co., has an average price-earnings ratio of 12—less than half the 30 ratio of the S&P 500, based on the new core earnings measure. Lehman's fund is up 6.4% this year. "I buy washed-out stocks," says Lehman. "It's the antithesis of momentum investing."

All the same, diversified stock-fund's results still look paltry compared with precious-metals funds, which gained 59% so far this year. Meantime, managers who short stocks still rank high among the top-50 funds.

Making money in this market is not just a matter of spurning growth stocks or the tech sector, or even piling into small-company stocks. Managers say it's very difficult to find investing themes that still work. Cyclical stocks tied to economic recovery have long been run up. Battered growth stocks won't pick up steam as long as the earnings rebound is so-so. "Value stocks aren't cheap, and the growth stocks aren't

growing," says George Boyd, head of equities at New York's Weiss Peck & Greer, which manages \$18 billion in assets. "Looking for companies that generate sales and earnings is just as important as looking for dividend yields and free cash flow."

That's where stock-picking prowess makes all the difference. Managers' most consistently profitable investments have been small- and mid-cap companies. While a yearlong rally has ironed out most of their once-huge disparities in value relative to large stocks, fund managers

How the Big Funds Fared

FUND	NET ASSET BILLIONS	TOTAL RETURN*
FIDELITY MAGELLAN	\$71.9	-13.08%
VANGUARD 500 INDEX	69.0	-11.75
INVESTMENT CO. OF AMERICA A	55.2	-5.77
WASHINGTON MUTUAL INVESTORS A	50.9	-3.84
GROWTH FUND OF AMERICA A	36.3	-13.24
FIDELITY CONTRAFUND	32.6	-0.19
FIDELITY GROWTH & INCOME	32.1	-8.24
EUROPACIFIC GROWTH A	27.9	-3.76
NEW PERSPECTIVE A	27.9	-6.04
AMERICAN CENTURY ULTRA INV.	24.4	-10.24

*Appreciation plus reinvestment of dividends and capital gains before taxes, Jan. 1 through June 14

Data: Standard & Poor's

MIDYEAR
INVESTMENT
GUIDE

The Best Equity Returns

FUND	TOTAL RETURN*	FUND	TOTAL RE
U.S. GLOBAL INV. WDRLD PREC. MINERALS	107.18%	OPPENHEIMER GOLD & SPEC. MINERALS A	40
U.S. GLOBAL INV. GOLD SHARES	96.21	VAN ECK TROIKA DIALOG A	37
FIRST EAGLE SOGEN GOLD	84.21	FRANKLIN GOLD & PRECIOUS METALS ADV.	36
VAN ECK INTL. INVESTORS GOLD A	75.70	VANGUARD PRECIOUS METALS	36
GABELLI GOLD	68.75	THIRD MILLENNIUM RUSSIA	35
TDCQUEVILLE GOLD	68.03	U.S. GLOBAL INV. GLOBAL RESOURCES	35
RYDEX DYNAMIC VENTURE 100	66.54	RYDEX ARKTOS INV.	33
MONTEREY OCM GOLD	66.46	ISHARES MSCI SOUTH KOREA INDEX	33
PRDFUND ULTRASHORT DTC PROFUND INV.	65.19	POTOMAC OTC SHORT	32
AMERICAN CENTURY GLOBAL GOLD INV.	63.02	ING RUSSIA A	32
AXP PRECIOUS METALS Y	61.22	FIDELITY ADVISOR KOREA A	31
EVERGREEN PRECIOUS METALS HOLDINGS I	61.01	MATTHEWS KOREA	30
USAA PRECIOUS METALS & MINERALS	59.73	TDCQUEVILLE INTERNATIONAL VALUE	26
ING PRECIOUS METALS A	59.12	SECURITY CAPITAL EUROPEAN REAL ESTATE	25
SCUDDER GOLD & PRECIOUS METALS S	54.88	U.S. GLOBAL ACCOLADE REGENT EAST. EURO	25
INVESCO GOLD INV.	53.22	RYDEX DYNAMIC TEMPEST 500	24
FIDELITY SELECT GOLD	49.62	PROFUND ULTRABEAR PROFUND INV.	24
MIDAS	48.42	PRUDENTIAL NATURAL RESOURCES Z	24
PRUDENT BEAR	44.98	AXA ROSENBERG VALUE MKT. NEUTRAL INV.	23
RYDEX PRECIOUS METALS	44.63	EATON VANCE ASIAN SMALL COMPANIES A	21

*Appreciation plus reinvestment of dividends and capital gains before taxes, Jan. 1 through June 14

Data: Standard

say there are still gems among them. These companies have mostly avoided accounting and management scandals and regulatory scrutiny. And they're less vulnerable than multinationals to currency fluctuations. "There are really good companies in the middle that have just been ignored," says Mark L. Henneman, lead manager of the \$360 million First American Mid-Cap Value Fund, up 6% this year. Henneman says earnings prospects for the mid-cap sector are above-average, and the stocks are still mostly cheap: Companies in the S&P MidCap 400, for instance, sell at a 26% discount to the S&P 500 on a price-to-sales basis, and a 24% discount on a price-to-book value comparison.

The pros say such mid-cap value stocks continue to have strong momentum. Large managers digging down in their search for growth and small-cap managers reaching for more liquidity will fuel future gains. Even managers with mandates to buy across all classes and geographic markets are hoarding on the middle ground. For instance, the Contrarian Fund, an all-cap, world stock fund, is up 10.4% this year—without any short-selling its charter allows. Manager Andy Pilara committed to low-multiple, mid-cap U.S. companies. "It's the most promising market right now," Pilara, whose purchases include companies as Pathmark Stores and Chiquita Brand.

Growth-stock managers who are price-conscious and have sidestepped the large growth companies are ahead. One of the best, Tom Mars, has been piling into stocks such as General Motors, and owning technology. He sold his Tyco International stake in the quarter, before its resignation sent the stock plunging in June. One of his top holdings is Healthcare, a Barbara (Calif.) ny, which runs

The Best Bond Funds

TOP 10 TAXABLE BOND FUNDS

	TOTAL RETURN*
GMD EMERGING COUNTRY DEBT IV	8.41%
LDDMIS SAYLES GLOBAL BOND RETAIL	8.25
STANDISH INTERNATIONAL FIXED INCOME II	8.08
UBS GLOBAL BOND Y	7.96
MS INSTL. INTL. FIXED INCOME	7.53
CDC INVEST STRATEGIC INCOME Y	7.50
OPPENHEIMER INTL. BOND A	7.30
TEMPLETON GLOBAL BOND ADV.	7.20
FEDERATED INTL. BOND A	7.10
NORTHEAST INVESTORS	7.00

TOP 10 TAX-FREE BOND FUNDS

	TOTAL RETURN*
FIRST INVESTORS INS. INTERM. TAX EXEMPT A	6.18%
FIRST INVESTORS INSURED TAX EXEMPT II	5.90
NUVEEN HIGH YIELD MUNI BOND R	5.72
PIMCO MUNICIPAL BOND A	5.70
OPPENHEIMER NJ MUNICIPAL A	5.55
STRONG INTERMEDIATE MUNI BOND INV.	5.54
OPPENHEIMER ROCHESTER NATIONAL MUNI A	5.45
SCUDDER MA TAX FREE S	5.45
TIAA-CREF TAX EXEMPT BOND	5.35
SMITH BARNEY INTM. MATURITY NY MUNI L	5.34

*Appreciation plus reinvestment of dividends and capital gains before taxes, Jan. 1 through June 14

Data: Standard & Poor's

The Worst Equity Returns

	TOTAL RETURN*	FUND	TOTAL RETURN*
INDS ULTRA OTC PROFUND INV.	-55.11%	RYOEX TELECOMMUNICATIONS INV.	-41.77%
INDO HEALTH & BIOTECH A	-54.72	DPPEHMEIER EMERGING TECHNOLOGIES Y	-41.13
D GENOMICSFUND.COM	-53.90	PIMCO RCM BIOTECHNOLOGY O	-40.95
WGDNER PDST-VENTURE	-52.79	ALLIANCE SELECT INV. BIOTECHNOLOGY A	-40.71
DAK EMERGING TECHNOLOGY	-52.41	FIOELITY SELECT BIOTECHNOLOGY	-40.60
WAGONER EMERGING GRDWT	-51.11	STREETTRACKS MS INTERNET INDEX	-40.51
EREY MURPHY NEW WORLD BIOTECH.	-50.61	KOPP EMERGING GROWTH INSTL.	-40.17
WAGDNER TECHNOLOGY	-49.75	MARKETOCRACY MEDICAL SPECIALISTS	-39.92
HAND TECHNOLOGY INNOVATDRS	-46.40	FIDELITY ADVISDR BIDTECHNOLOGY A	-39.89
TEX MEDICAL SCIENCES A	-46.35	RYDEX INTERNET ADV.	-39.86
ITY SELECT WIRELESS	-45.30	FIOELITY SELECT DEVELDP. COMM.	-39.84
ER BIO TECH2 A	-45.26	ISHARES DJ U.S. INTERNET INDEX	-39.82
BIOTECHNOLOGY INV.	-44.79	RS INFORMATION AGE A	-39.71
HAND COMMUNICATIONS	-44.74	MONTEREY MURPHY NEW WORLD TECH.	-39.64
ES NASDAQ BIOTECHNOLOGY	-44.57	CONSECD SCIENCE & TECHNOLOGY Y	-39.60
ES GOLDMAN SACHS NETWORKING INDEX	-44.04	FRANKLIN BIOTECHNOLOGY DISCOVERY A	-39.55
CO TELECOMMUNICATIONS INV.	-43.68	MUNDER NETNET A	-39.43
LDBAL BIOTECH Y	-43.60	ORBITEK EMERGING TECHNOLOGY A	-38.24
JORGAN H&Q TECHNOLOGY B	-42.92	WWW INTERNET	-38.01
HAND TECHNOLOGY VALUE	-42.40	IDEX PBHG TECHNOLOGY & COMM. A	-37.98

*Appreciation plus reinvestment of dividends and capital gains before taxes, Jan. 1 through June 14

Data: Standard & Poor's

facilities for neurology, orthopedics, and car-
cular patients. It has paid down debt, Mar-
ys, and trades at less than 18 times esti-
2003 earnings. Stock picks like that make
5 billion, 27-stock Marsico Focus Fund,
is up 3.5%, the No. 1 large-cap growth
this year.

For managers who buy unpopular stocks
also been amply rewarded—especially if
concentrated on those with earnings and
es below industry averages. David H. El-
who runs Friedman Billings Ramsey's Fi-
Services fund, which is up 9.6%, is one.
vs plain-vanilla companies such as Sun-
Golden West, and Charter One Financial
ing light on "large, complicated corporate
er-oriented companies," like Citigroup and
Lynch. "I want guys who make loans
everyone can understand," he says.

fund managers face real challenges in
ting their strong results of the past two
Interest rates are unlikely to get any
That puts an end to bets on falling rates,
mortgage-backed securities. The answer,
Eugene Flood Jr., president of the Chapel
(J.C.) bond shop Smith Breeden Associ-
to buy bonds maturing in one to three
that will lose less when interest rates rise.
th prefers bonds backed by auto loans or
card fees, which also yield more with the
redit rating than corporates.

ever, not all managers are avoiding cor-
bonds. Kenneth J. Hart, co-manager of
7 million Sentinel Bond Fund, says
s such as WorldCom's have unfairly taint-
whole corporate market, making it the
st in the fixed-income realm. His man-

date is to figure out if a company's bond price is
down for technical or fundamental reasons. Late-
ly, he has been buying the A-rated debt of Coors
Brewing, Merrill Lynch, Sears, IBM, and General
Electric. So far this year, his fund is up 1.7%.

Active fund managers have made the most of a
bad market. But investors are a fickle lot. The flow
of new money has been erratic so far this year.
And managers won't get much thanks until dis-
gruntled investors start to make real money. ■

Gold and Overseas Funds Sparkle

	TOTAL RETURN*		TOTAL RETURN*
PRECIOUS METALS	58.99%	LATIN AMERICA	-7.33%
REAL ESTATE	10.65	LARGE-CAP VALUE	-7.54
PACIFIC/ASIA EX-JAPAN	9.72	LARGE-CAP BLEND	-11.29
DIVERSIFIED EMERGING MKTS.	9.07	UTILITIES	-12.94
DIVERSIFIED PACIFIC/ASIA	7.08	MID-CAP GROWTH	-13.43
JAPAN	5.34	SMALL-CAP GROWTH	-14.53
NATURAL RESOURCES	5.13	LARGE-CAP GRDWT	-15.24
INTERNATIONAL BOND	3.83	HEALTH	-23.29
EMERGING MARKETS BOND	3.46	TECHNOLOGY	-30.07
SMALL-CAP VALUE	1.24	COMMUNICATIONS	-32.78
FINANCIAL	-0.03	ALL EQUITY AVERAGE	-8.02
HIGH YIELD	-0.80	ALL BOND AVERAGE	2.92
MID-CAP VALUE	-1.87	ALL TAXABLE BOND AVERAGE	2.17
SMALL-CAP BLEND	-4.92	ALL NON-TAXABLE BOND AVG.	3.75
EUROPE	-5.38	INTL. EQUITY FUND AVERAGE	-1.61
MID-CAP BLEND	-6.43	U.S. DIVERSIFIED FUNDS	-10.11

*Appreciation plus reinvestment of dividends and capital gains before taxes, Jan. 1 through June 14

Data: Standard & Poor's

MIDYEAR
INVESTMENT
GUIDE

Don't Fear Rising Rates

Smart bond strategies can still pay off

BY SUSAN SCHERREIK



On the face of it, the picture doesn't look that bright for bonds. The Federal Reserve is widely expected to begin hiking interest rates before yearend. Credit-rating downgrades continue to plague Corporate America. And there are fears the weakening dollar could prompt foreign investors to start dumping their sizable holdings of U.S. debt.

If bonds look scary, stocks probably look even more so. So like it or not, investors need to find a way to invest comfortably in bonds.

Take, for example, the prospect of Fed rate hikes. At such a time, investors are typically advised to stick with shorter maturities, so they're not locked into below-market returns. But since no one can predict when the Fed will reverse course, some bond pros recommend a "barbell" strategy, in which you split your holdings between short (up to six months) and long (10 to 15 years) maturities. If rates rise, you can reinvest the proceeds of short-term bonds when they ma-

ture. And just as 10- to 15-year bonds budged during the Fed's easing, some pros expect them to hold fairly steady if rates move up.

You also need to keep your portfolio diversified to protect against deterioration in credit quality. On that count, mortgage-backed securities issued by Ginnie Mae, Freddie Mac, and Ginnie Mae are your best bet. These securities yield about 1.9 points more than comparable U.S. Treasury securities. Kevin Cronin, senior investment officer for fixed income at Putnam Investments, says mortgage-backed securities will perform well if interest rates stay steady, which he expects to be the case over the next few months. But when rates rise, he says, the yield on mortgage-backed securities will help cushion any price declines.

What about Treasuries?

Cronin says they've become pricey as investors have flocked to safety amid a sagging stock market and Middle East turmoil. The yield on 10-year government notes slipped to 4.8% on June 14, the lowest level this year. Cronin believes Treasury prices will head south again if Washington ramps up bond sales to finance the mounting budget deficit. For Treasury debt, individual investors might fare better with either Series I savings bonds or Treasury Inflation-Indexed Securities (TIPS), both of which adjust the interest rate periodically to protect against inflation (table).

If you can tolerate more risk, corporate bonds beaten down to a lower investment grade even junk status, may be the way to go. Corporate bonds recently yielded as much as 10.5%. Unless you have a multimillion-dollar portfolio, you can hold a diversified mix of issues, stick with a bond fund. Two top-notch choices that have loaded up on the fallen debt of troubled telecom and energy companies are PIMCO Total Return, run by renowned bond manager Vincent P. Poirer, and Metropolitan West Total Return Fund. "We're at the bottom of the credit cycle," says Stephen Kane, co-manager of Metropolitan West. As the economy picks up, the fortunes of these battered companies should improve.

Also consider adding a fund that invests in foreign bonds. Since such debt gains in value when the dollar falls, these funds could generate some capital gains as well as interest income. Foreign bond funds focus either on industrial nations or emerging markets. Two examples: T. Rowe Price International Bond Fund, up 7.02% this year through June 14, and Emerging Markets Bond, up 2.84%.

Bonds would be easy to write off today, but you can find investments that should steady up, not pump up, your overall portfolio.

MIDYEAR INVESTMENT GUIDE

Smart Bond Plays

INVESTMENT

T. Rowe Price International Bond Fund (RPBIX)

Treasury Inflation-Indexed Securities

Vanguard GNMA Fund (VFIIX)

COMMENT

Will benefit if the U.S. dollar continues to erode. With the dollar falling against the major currencies, this fund is up 7.02%* so far this year, and the current yield is 3.23%.

A better bet than plain Treasuries as long as inflation rises at more than a 1.75% annual clip over the next decade. Many economists see the long-term inflation rate at 2.5%.

This no-load fund, which focuses on the top credit-quality mortgage securities backed by Ginnie Mae, recently yielded 5.80%. The tiny, 0.27% expense ratio helps a lot.

*Through June 14

Data: Morningstar Inc., Banc of America Securities



hp LaserJet 9000 mfp

**To succeed
in business
today,
you need
to network.**



An HP Multifunction Printer has the social skills to work with other machines. But networkability is just part of an MFP's skillset. It can also copy, print, color scan and fax. That means you can replace up to four machines with one MFP. If you have an Internet connection, you can even scan documents and e-mail them in one step. Our MFPs also come with the reliability and support you expect from HP. To find out more, call 888-355-9836 and mention source code 12142 or visit www.hp.com/go/mfp99. A copier isn't as well equipped to make it in today's business environment.

Back in the Comfort Zone

A few munis in your portfolio let you sleep at night

BY SUSAN SCHERREIK



Although it's supposed to be a relatively safe haven, the municipal-bond market has taken some big hits lately. The economic slowdown has thrown state and city budgets out of whack as revenues fall far short of spending plans made just a year ago. Credit agencies have been downgrading municipalities, especially big borrowing states like California and New Jersey. And localities everywhere are pumping out new debt to tide them over.

Against this background, it's important to stick to top-quality bonds. That's not hard be-

cause half of all munis carry a triple-A rating. The vast majority get that rating because they are insured, which guarantees investors timely payment of interest and principal even if the issuer defaults. The largest muni bond insurers—Ambac, Financial Guaranty Insurance, Financial Security Insurance, and MBIA—are sound companies and have paid claims in the few instances when they have defaulted, says Howard Mischele, a director at Standard & Poor's.

Since muni bond issuers rarely default, is insurance overkill? No, since insured bonds hold their value better if an issuer's credit rating drops. With most states facing deficits, a few more credit downgrades are likely this year. States that S&P is monitoring for possible credit-rating cuts include Arizona, California, and Colorado.

Insured bonds have other pluses. It is easier to compare the credit quality of insured bonds. Also, they trade more actively than other bonds, so investors can more easily buy and sell. Insured muni bond funds are a different matter. Morningstar analyst Eric Jacobson says they tend to offer slightly lower yields while charging above-average expenses. Because a fund manager closely monitors the credit quality of insured bonds, insurance is less of an issue.

To further protect yourself, Mary Miller, head of muni bond investing at T. Rowe Price, suggests sticking to bonds backed by user fees for essential services, such as water and sewer. Conversely, you may want to skip bonds backed by sales taxes, since revenues from that source can shrink during economic downturns, she says.

Mark McCray, head of muni bond investing at PIMCO, says investors often overlook the importance of having a geographically diversified portfolio. True, it makes sense for a resident of a high-tax state like California or New York to load up on the bonds of their localities because they can then qualify for an exemption from federal, state, and, if applicable, city tax. Putting a slice of your portfolio in a national muni bond fund, however, you guard against an unforeseen disaster such as a major earthquake in California (table).

It seems prudent to stick to the shortest maturities since the the Federal Reserve is expected to raise interest rates later this year. Marilyn Cohen, head of Envision Capital Management, a bond investment firm in Los Angeles, says that with munis maturing in 2010 yielding 1.6%, the strategy isn't lucrative. She believes the best deal now are issues maturing in 10 years, which recently yielded 4.1% to 3.25% for five years. With the federal tax exemption, that 4.10% yield translates into an after-tax yield of 5.86% for an investor in the 30% marginal tax bracket.

It's rare for an investment nowadays to provide decent yields and let you sleep at night. That's why munis belong in most portfolios.

Best Muni Bond Bets

MUTUAL FUNDS

NAME/SYMBOL	YIELD*	COMMENT
Fidelity Spartan Municipal Bond FHIGX	4.15%	Long-term bonds, low risk, modest 0.43% expense ratio
Vanguard Intermediate-Term Tax-Exempt VWITX	3.73	Solid performer with rock-bottom 0.19% expense ratio

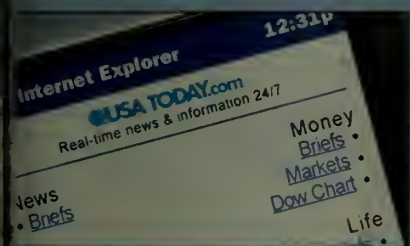
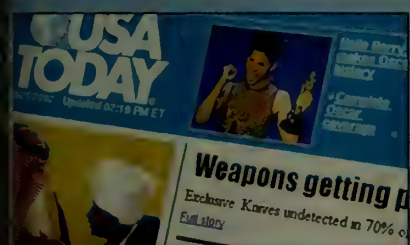
INSURED MUNICIPAL BONDS

NAME	YIELD*	COMMENT
Fairport N.Y. Central School District 4.125% G.O. June '12	4.10%	Noncallable, pays 90% of comparable Treasuries
U. of California 4.0% Revenue Bonds Sept. '12	4.10	Backed by the university's general revenues

*June 14

Data: Morningstar Inc., Envision Capital Management Inc.

WAKE UP



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A NEW FUND RIDES THE BIG MO'



BY ROBERT BARKER
rb@businessweek.com

Based on the momentum theory that rising stocks tend to keep rising a while, Rydex' method has been racking up some good numbers. But there are caveats

Hideous truth hurts, but here it is, a recap of the New Millennium: \$10,000 invested on Jan. 1, 2000, in the Wilshire 5000 Total Market Index was worth \$7,124 by mid-June. In the typical aggressive-growth mutual fund, 10 grand shrank to 6.4 grand. In the Munder NetNet Fund, it sank to \$1,533. If you had \$10,000 in stock of Lucent Technologies, it was down to shares worth \$526. Enron? \$24.11.

Amid this depressing reality, the fastest-growing new mutual fund has sucked in more than \$100 million in just 12 weeks. Rydex Sector Rotation Fund is the latest invention of Rockville (Md.)-based Rydex Funds, which has gone from managing zero in 1993 to \$5.5 billion. Its Sector Rotation Fund is catching on because investors "realize that just buying [equity] exposure and sticking with it isn't the way to go," the fund's portfolio manager, Charles Tennes, told me. "People like the built-in sell discipline."

What he means is his fund does not hold anything unless it's hot. Tennes examines 59 industry groups of stocks each month and ranks them by their price strength over the prior year. Next, he picks the top dozen or so industries and buys enough stock from each to give each industry an equal weighting in his portfolio. Recently, that yielded a fund with about 200 stocks from 14 groups (table). Next month, Tennes will dump stocks from any industry falling out of the top ranks and add stocks from comers.

Based on the "momentum" theory that rising stocks tend to keep rising, sector strategies are nothing new and have a mixed record. But in a hypothetical "backtest," Rydex' model beat the Standard & Poor's 500-stock index by a mile—an annual average return of 26.6% vs. 12.7% in the six years ended last Dec. 31. Those results con-

firmed similar tests by S&P Chief Sector Strategist Sam Stovall, author of the book, *Sector Investing*. He sees the fund as so promising that he put some of his own money in it.

Yet before you hide from the bear in rotation, it's worth seeing just how safe this fund might be. First, it isn't cheap. Expenses come to 1.8% of assets, and are yet, 2.55%, if you buy the Class C shares s-brokers. Morningstar puts the average do stock-fund cost at 1.44%. Second, there's a chance the fund will trade often, perhaps c a steep capital-gains tax bill. So the fund is bet for taxable accounts. Stovall, no fool, his fund shares in a tax-deferred retirement account. He also notes that investors should putting their entire equity allocation into rotation. "It's not a conservative approach" vesting, Stovall told me.

The big danger can be seen from the ta this page: What are hot at any time tend to be similar sorts of stocks—right now,

ample, it's food, hold, and other plays. Because fund is less diversified, its values to fluctuate more wildly than the market. The backtest, the model was more volatile than the S&P 500.

The second is whether

can do as well or than the model, while the backtest ran monthly. For example, it exactly 10 industries month, while Tennes industry groups make roughly the top ranked by performance. That could be 10 industries or a few more or Tennes also uses as gut as science in deciding whether to keep, say, industry stock that's hot on merger talk. A tested model "is stupid we like to think smarter," Tennes said.

In its brief life, the fund is off 3% compared to a 12% loss in the S&P 500. For most money managers, that's fine. However, Tennes was happy unless the market makes money. In a market, that may be more than investors can count on.



Rydex' Sector Picks

INDUSTRY GROUP	TYPICAL STOCK/SYMBOL
Air freight and logistics	Ryder System/R
Auto components	Delphi/DPH
Beverages	Anheuser-Busch/BUD
Building products	American Standard/ASD
Containers and packaging	Bemis/BMS
Food products	Sara Lee/SLE
Health-care providers and services	Aetna/AET
Hotels, restaurants, and leisure	Carnival/CCL
Household durables	American Greetings/AM
Household products	Clorox/CLX
Personal products	Alberto-Culver/ACV
Real estate	Equity Office Properties Trust/EOP
Tobacco	Philip Morris/MO
Trading companies and distributors	W. W. Grainger/GWW

Data: Rydex Funds, Standard & Poor's

BusinessWeek online

For barker.online, go to www.businessweek.com/investor/ and click on "Columns"



**IRONICALLY, YOUR COMPANY'S
HUMAN RESOURCES
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MOVADO: TIME-TESTED



BY GENE G. MARCIAL

Why luxury-goods maker Movado is a bargain. More to go for gold: Demand will keep outpacing supply. Toys 'R' Us may be fun and games again for investors

Although Movado Group (MOV) is the designer and maker of such well-known upscale, artsy watches as Movado and Concord, it's hardly an industry giant. Sales in fiscal 2002 were \$300 million, and Movado's global market share is just 2.3%. But in the last 12 months, the stock has outscored other luxury-goods companies such as Gucci and Tiffany—and yet still trades at a steep discount to their shares.

Movado has bucked the overall market, rising from 14 a share on Sept. 24 to 21 on June 19. Selling at 11.2 times next year's projected earnings of \$1.86 a share, for the fiscal year ending Jan. 31, 2004, it's trading at a "too-severe discount" to the luxury industry's average price-earnings ratio of 20.4, says Paula Kalandiak of Wells Fargo Securities, who rates Movado a buy. The analyst doesn't own the stock, and Wells Fargo hasn't had deals with Movado. Kalandiak says that with its strong brand in premium watches, Movado has huge potential to grow in the \$13 billion industry. Selling directly to big department and specialty stores in 60 countries, it also competes in the nonluxury watch market with its Tommy Hilfiger, Coach, and Esq brands.

Movado's boutique stores, which sell its own jewelry exclusively, are highly profitable and deliver rich margins, says Kalandiak. In fiscal 2002, Movado earned \$1.43 on \$299.7 million in sales. Kalandiak's 12-month stock price target is 28, or 15 times her fiscal 2004 forecast. Her 2003 estimate is \$1.62 a share, on \$320.7 million in sales.

Some pros say Movado would trade higher were it not for its dual stock. Its Class A shares, controlled by the family of Chief Executive Efraim Grinberg, has 10 votes a share. Grinberg concedes that Class A "is there as an anti-takeover device." Many companies are interested, he says, "but we aren't for sale—although we're always looking for opportunities for our shareholders." He wouldn't say whether Swatch Group, a big watchmaker with 18 brands and a 20% market share, is among those interested.

WILL GOLD BUGS BUZZ AGAIN SOON?

With gold prices much higher and gold stocks also up sharply after a 20-year slump, most investors think it's over for this gold rush. Prices of gold and gold shares have been sliding in recent days. "Investors think the party is over for gold. Wrong," says Vince Carino, president of Brookhaven Capital Management. "Gold shares will continue to outpace the market this year at

least," he says. It's simply a case of demand metal outpacing supply, argues Carino, who has been buying shares of Newmont Mining and Barrick Gold (ABX). Newmont is up 15% from last July to 32 on June 4, 2002—before easing to 28 on June 19. Barrick, at 13 in November, rose to 23 in late May—before slipping to 19 on June 19. Michael Durose of Morgan Stanley says the recent drop in gold stocks is healthy, given the group's upswung year-to-date. The XAU

gold index, which tracks a basket of stock prices, is up 38% this year, and the metal has risen from an ounce to \$320. Durose says the weak geopolitical uncertainty, low real interest rates, and industry consolidation are positive for gold.

Carino predicts the price will leap to \$400 this year and rise to \$400 an ounce in 2003. At those prices, Newmont and Barrick will be good buys, he figures. With that, he says, "gold will gain acceptance as a solid investment vehicle."

CARINO'S GOLD BEATS

STOCK	JUNE 19 CLOSE	52-WEEK HIGH-LOW
NEWMONT	28	32-17
BARRICK	19	23-13

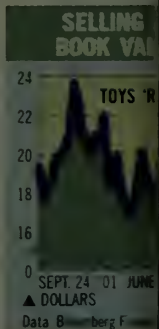
Data: Brookhaven Capital Management, Bloomberg Financial Markets



TOY STORY: TOO CHEAP TO IGNORE

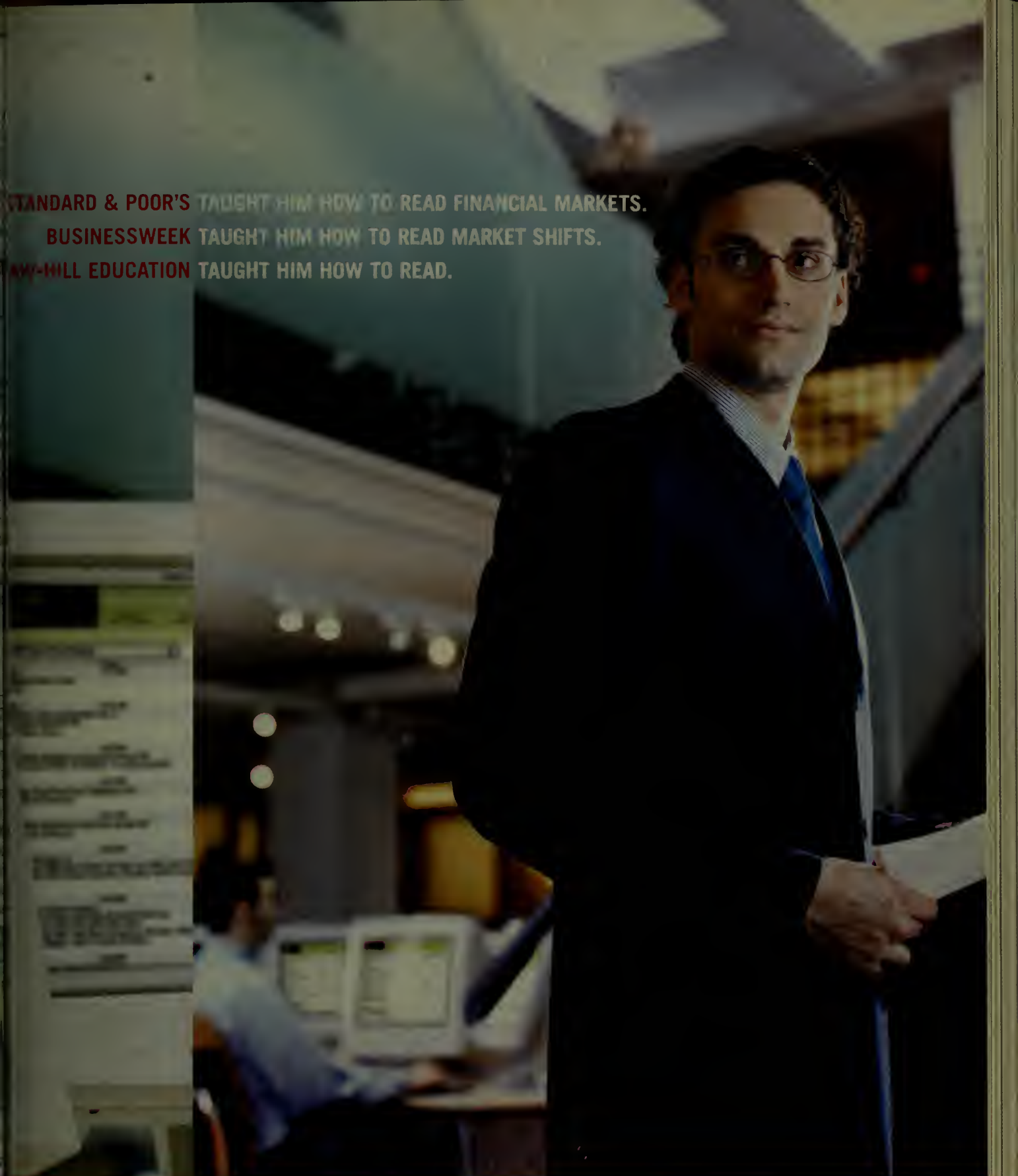
Investors have long shunned shares of Toys 'R' Us (TOY), and for good reason: They didn't see much further growth ahead. Its stock has slid from 28 a year ago to 17 on June 19. But Tom Kuensell, managing director of Brandywine Asset Management, Toys is now too cheap to ignore. Its stock is trading at 13.6 times his 2003 estimate of \$1.25 a share—and selling at book value. That makes it way undervalued, based on its real estate assets alone, says Kuensell, who has been buying shares. Toys owns 540 stores—most acquired in the 1980s at depressed prices. And it has a strong balance sheet with debt at 34% of capital.

In 2001, Toys started streamlining its stores to get away from the warehouse look. They're brighter, with wider aisles that make it easier to find items. Melissa Comer Williams of Gerard Klauer Mainetti has raised estimates for the year ending Jan. 31, 2003, to \$1.15 from \$1.10, and to \$1.35 in 2004. Williams, who doesn't own the stock, rates Toys a buy. Her 12-month price target is 25. (Gerard Klauer performed bankruptcy restructurings for Toys in the past three years.)



BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column afternoons at www.businessweek.com/today.htm. And Fridays at 1:40 p.m. EST on CNN's *The Money* Channel.



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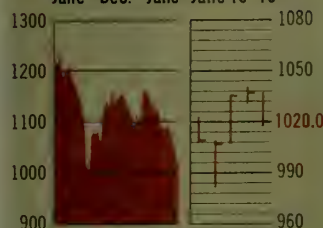
AVIATION WEEK

McGraw Hill
CONSTRUCTION

Stocks

S&P 500

June Dec. June June 13-19



COMMENTARY

Stocks seasawed once again this week as investors reacted to any shred of news, good or bad. On June 17, shares rose strongly on news that McDonald's expects to exceed its profit forecast. Two days later, though, equities fell just as sharply on lowered forecasts by AMD and Apple. For the week, the S&P 500 was unchanged, while the Dow and Nasdaq lost 0.6% and 1.5%.

Data: Bloomberg Financial Markets
Reuters

U.S. MARKETS

	June 19	Week	Year to date	Last 12 months
S&P 500	1020.0	0.0	-11.2	-15.9
Dow Jones Industrials	9561.6	-0.6	-4.6	-9.8
Nasdaq Composite	1496.8	-1.5	-23.3	-24.9
S&P MidCap 400	502.9	0.8	-1.1	-0.3
S&P SmallCap 600	232.1	0.5	0.0	5.8
Wilshire 5000	9658.2	0.0	-9.8	-13.7

SECTORS

	June 19	Week	Year to date	Last 12 months
BusinessWeek 50*	649.7	0.8	-11.0	-23.1
BusinessWeek Info Tech 100**	307.0	-3.4	-26.8	-31.4
S&P/BARRA Growth	510.7	-0.7	-14.1	-15.5
S&P/BARRA Value	506.5	0.6	-8.2	-16.7
S&P Energy	212.2	0.2	0.4	-12.0
S&P Financials	345.7	2.1	-2.7	-8.0
S&P REIT	100.8	-0.2	7.9	8.6
S&P Transportation	198.4	-1.7	0.7	3.7
S&P Utilities	126.8	1.7	-13.1	-33.2
GSTI Internet	79.3	2.3	-24.4	-33.1
PSE Technology	535.6	-1.3	-22.1	-23.6

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Managed Health Care	8.4	65.8
Health-Care Facilities	8.0	59.2
Health-Care Supplies	7.2	56.1
Divsfd. Metals & Mining	4.1	49.5
Homebuilding	3.3	41.1

EQUITY FUND CATEGORIES

4-week total return	%	52-week total return	%
Leaders		Leaders	
Real Estate	2.5	Precious Metals	66.7
Financial	-1.9	Real Estate	15.1
Domestic Hybrid	-2.1	Small-cap Value	9.1
International Hybrid	-2.6	Diversified Emerging Mkts.	6.9
Laggards		Laggards	
Latin America	-10.6	Communications	-38.6
Technology	-10.0	Technology	-34.4
Communications	-9.7	Utilities	-22.5
Japan	-7.1	Health	-21.3

EQUITY FUNDS

4-week total return	%	52-week total return	%
Leaders		Leaders	
Rydex Dynamic Vent. 100	19.1	U.S. Glob. Wid. Prec. Mins.	103.9
ProFunds UltraShort OTC	19.0	First Eagle SoGen Gold	98.4
Rydex Arkos Investor	9.6	U.S. Global Investors Gold	95.8
Potomac OTC Short	9.5	Van Eck Intl. Invs. Gold A	89.0
Laggards		Laggards	
Black Oak Emerging Tech.	-22.7	ProFunds UltraOTC Inv.	-63.4
ProFunds UltraOTC Inv.	-18.9	Black Oak Emerging Tech.	-63.2
Kopp Emerging Gr. Retail	-17.7	Van Wagoner Post Venture	-62.0
Van Wagoner Post Venture	-17.0	Van Wagoner Technology	-60.4

Data: Standard & Poors

GLOBAL MARKETS

	June 19	Week
S&P Euro Plus (U.S. Dollar)	991.9	-0.7
London (FT-SE 100)	4652.4	-4.1
Paris (CAC 40)	3935.6	-1.7
Frankfurt (DAX)	4354.8	-3.4
Tokyo (NIKKEI 225)	10,476.2	-7.5
Hong Kong (Hang Seng)	10,673.1	-4.3
Toronto (TSE 300)	7247.8	-1.5
Mexico City (IPC)	6691.0	-1.6

FUNDAMENTALS

	June 18	Week
S&P 500 Dividend Yield	1.52%	
S&P 500 P/E Ratio (Trailing 12 mos.)	44.0	
S&P 500 P/E Ratio (Next 12 mos.)*	18.3	
First Call Earnings Revision*	-0.68%	

*First Call Corp.

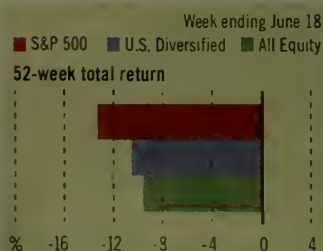
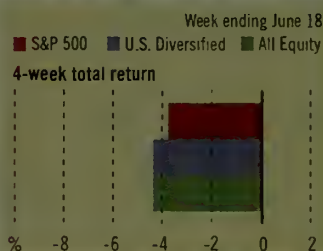
TECHNICAL INDICATORS

	June 18	Week
S&P 500 200-day average	1106.4	11
Stocks above 200-day average	64.0%	
Options: Put/call ratio	0.88	
Insiders: Vickers NYSE Sell/buy ratio	4.10	

WORST-PERFORMING GROUPS

	Last month %	Last 12 months %
Wireless Services	-39.5	Multi-Utilities
Semiconductors	-30.4	Wireless Service
Advertising	-29.8	Computer Stge
Semiconductor Equipment	-26.5	Telecomms. Eq
Instrumentation	-23.6	Application Sof

Mutual Funds



Data: Standard & Poors

Interest Rates

KEY RATES

	June 19	Week
MONEY MARKET FUNDS	1.51%	1.5
90-DAY TREASURY BILLS	1.70	1.7
2-YEAR TREASURY NOTES	2.77	3.0
10-YEAR TREASURY NOTES	4.73	4.9
30-YEAR TREASURY BONDS	5.39	5.5
30-YEAR FIXED MORTGAGE†	6.55	6.7

†BancQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENT

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 30% federal tax rate.

	10-yr. bond
GENERAL OBLIGATIONS	4.09%
TAXABLE EQUIVALENT	5.84
INSURED REVENUE BONDS	4.25
TAXABLE EQUIVALENT	6.07

THE WEEK AHEAD

FOMC MEETING Tuesday, June 25, 9 a.m.

EDT ► The Federal Reserve Board's Open Market Committee meets for two days to set monetary policy. Economists surveyed by Standard & Poor's MMS, a division of The McGraw-Hill Companies, unanimously expect the Fed to leave the federal funds rate at 1.75%.

CONSUMER CONFIDENCE Tuesday, June 25, 10 a.m. EDT

► The Conference Board's June confidence index is forecast to have slipped back to 107.8, from 109.8 in

May. That's based on the median forecast of economists surveyed by S&P's MMS.

EXISTING HOME SALES Tuesday, June 25, 10 a.m. EDT

► Sales of existing homes in May probably slipped 1.7%, to an annual pace of 5.69 million.

DURABLE GOODS ORDERS Wednesday, June 26, 8:30 a.m. EDT

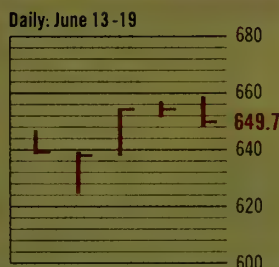
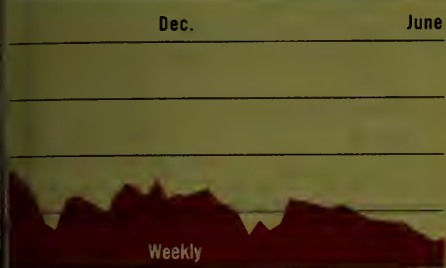
► New orders for durable goods most likely increased by 0.3% during May. In April, they climbed 1.5%.

NEW RESIDENTIAL SALES Wednesday, June 26, 10 a.m. EDT

► New single-home sales in May are expected to have remained unchanged from April at an annual pace of 915,000 homes.

PERSONAL INCOME Friday, June 27, 8:30 a.m. EDT

► Personal income for May probably increased 0.3%, while consumer spending most likely rose 0.1%. In April, income rose by 0.3%, but consumer purchases were up a more significant 0.5%.



p against the trend of the rest of the market, advancing 0.8% for the week ended June 19. rs was Tyco International, which soared 52.7% after receiving regulatory approval for its CIT he climbers was energy provider Calpine, which added 13.4%. Best Buy fell 10.3% for the ncing second quarter earnings would be off by a couple of pennies.

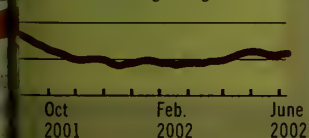
COMPANY PERFORMANCE

	% change		Rank	Company	% change	
	Week	Since 3/1/02			Week	Since 3/1/02
Inson	-1.5	-7.4	26	Tenet Healthcare	2.6	35.2
	1.7	2.3	27	Household International	-1.8	0.1
	2.1	-12.7	28	WellPoint Health Networks	2.0	41.8
	1.3	-3.3	29	Washington Mutual	0.1	15.0
	-2.2	4.3	30	Duke Energy	9.0	-7.0
Kohl's	-3.4	-18.1	31	Kohl's	-1.0	8.9
	1.8	0.2	32	Bed Bath & Beyond	-2.7	3.0
	-4.5	0.3	33	Cardinal Health	3.7	-2.7
	-10.3	-13.8	34	Centex	5.3	-3.2
	4.7	21.5	35	American Electric Power	1.9	-4.6
Group	0.3	34.2	36	Golden West Financial	-1.3	7.9
	2.0	10.1	37	Stryker	3.2	-11.8
	-1.1	-24.7	38	Harley-Davidson	-0.5	1.8
	-1.5	-7.4	39	PepsiCo	0.4	2.7
	5.1	-69.6	40	Merck	1.1	-14.3
mics	4.0	18.3	41	Apache	3.9	5.0
	2.1	-3.8	42	Amerada Hess	0.2	12.7
	2.5	-9.5	43	KB Home	1.8	15.3
	-1.4	-8.5	44	First Data	-2.5	-1.9
	13.4	19.7	45	Tyco International	52.7	-46.7
roleum	2.6	11.1	46	International Game Technology	-0.2	-13.2
	3.4	-6.7	47	Capital One Financial	3.0	19.2
	5.6	8.2	48	Electronic Data Systems	-1.8	-18.0
	3.5	-2.5	49	Nabors Industries	3.6	7.6
	2.1	-7.0	50	Xcel Energy	-7.4	-21.3

Production Index

Change from last week: 0.2%
Change from last year: -4.9%

OUTPUT June 8=161.5 1992=100
Index is a 4-week moving average



Index managed to increase for a second before calculation of the four-week index rose to 162.5, from 162. After the components were evened the biggest increase, followed by production, autos, and rail freight traf-oil refining and coal output were in the index. Truck assemblies and

the index components is at www.businessweek.com
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A HOLLOW VICTORY AGAINST ANDERSEN

Imposing the death penalty on Arthur Andersen LLP is a troubling precedent that raises serious ethical, public policy, and economic issues. No doubt the aggressive pursuit and conviction of the accounting firm by the Justice Dept. will throw a scare into other companies contemplating playing fast and loose with the law. But the cleanup under way in Corporate America would probably have benefited more had Andersen been reformed rather than killed. The furious lobbying effort in Congress by the remaining Big Four to water down reform legislation shows that making an example of Andersen is not nearly enough.

Better to have let former Federal Reserve Chairman Paul A. Volcker remake Andersen into a model firm for the entire accounting profession. Volcker promised to revamp the company's leadership and improve its corporate governance. He proposed splitting the auditing and consulting functions, thus removing the temptation to go easy on companies Andersen audited in hope of selling services. Had Volcker succeeded in transforming Andersen, other accounting firms might have followed suit. This could have restored investor confidence in the credibility of financial statements and the equity markets.

Instead of encouraging reform, the Bush Administration chose to prosecute Andersen for obstructing justice (page 34). It indicted not the individual partners but the firm itself. Yet only a small number of top Andersen managers are respon-

sible for Enron Corp.'s long history of accounting dishonesty. Before Enron, the firm was fined \$10 million by the SEC and the Justice Dept. for not doing a proper job in auditing Waste Management Inc. It also failed with Sunbeam, Boston Chicken, and the Baptist Foundation of America. Clearly, a culture of impropriety existed at Andersen, punishing 26,000 employees for the sins of the top few. It is unfair, especially since the partners themselves were to be shielded from personal liability.

In the end, Justice barely won against Andersen—a technicality, at that. The jury rejected the heart of the government's case, deciding that employees can't be held personally liable for following corporate guidelines on standard documents. This poor showing may be a blow to the government's case against Enron. Indeed, show trials against companies that generate few if any guidelines for reform have little economic value. The Justice Dept. believes that destroying Andersen will further the cause of corporate reform. We fear it may not.

Reforming Corporate America will require new rules. The private sector is writing them for CEO behavior and corporate governance. The government has to write them for auditing. Whether they come out of the SEC or Congress is another matter. The Bush Administration should move beyond execution to reform.

IN PRAISE OF BORING STOCKS

What's wrong with the market? Of the past 19 economic recoveries stretching back to 1912, the stock market has never been so weak, according to economist Ed Hyman at International Strategy & Investment Group. People are putting cash into their houses, buying bonds, or plowing money into mundane companies with low price-earnings ratios. Truth is, playing it safe is the right strategy for the moment for most investors (page 99). And the reason has less to do with corporate profits than with risk. When it comes to the economy, the road ahead is clear. When it comes to risk, there's no visibility.

The economic fundamentals for the U.S. are pretty healthy, despite jitters about a double-dip recession. Productivity growth is exceptionally strong. Wage gains are restrained. That translates into widening profit margins today and fatter profits as the year progresses. In past recoveries, investors began to place their bets on future profits growth early in the business cycle, sending overall stock prices higher in anticipation of better results.

Not so today. Risks are much harder to ascertain than in previous recoveries, making the valuing of stocks very difficult. Investors, for example, face the risk of getting false financial numbers from companies. With a record number of

companies restating past earnings and many other things going wrong, investors are unsure how much these companies are really worth. Naturally, there is a strong move afoot to clarify financial statements. The post-Enron uncertainty will soon end corporations' clean house.

But the political risks weighing on investors may not be over. The economy was stopped cold on September 11, and a terrorist attack could do terrible harm. The stream of warnings coming out of Washington is a constant reminder to investors of global instability. So is the talk of an invasion of Iraq to oust Saddam Hussein, which could set off a Middle East crisis and cut off the flow of oil. Until the Iraq crisis is resolved and terrorism is perceived to be under control, political risk will weigh heavily on investors.

Which is why the investment mantra of the day is to put money into companies whose businesses are boringly predictable, with balance sheets that are clear and prices that are relatively cheap. Paying dividends is a plus, and investing overseas is no longer a minus. Unlike the '90s, there is an unusual amount of risk in the world today, a kind that is particularly difficult to measure. Until investors get a handle on it, they are right to play it safe.

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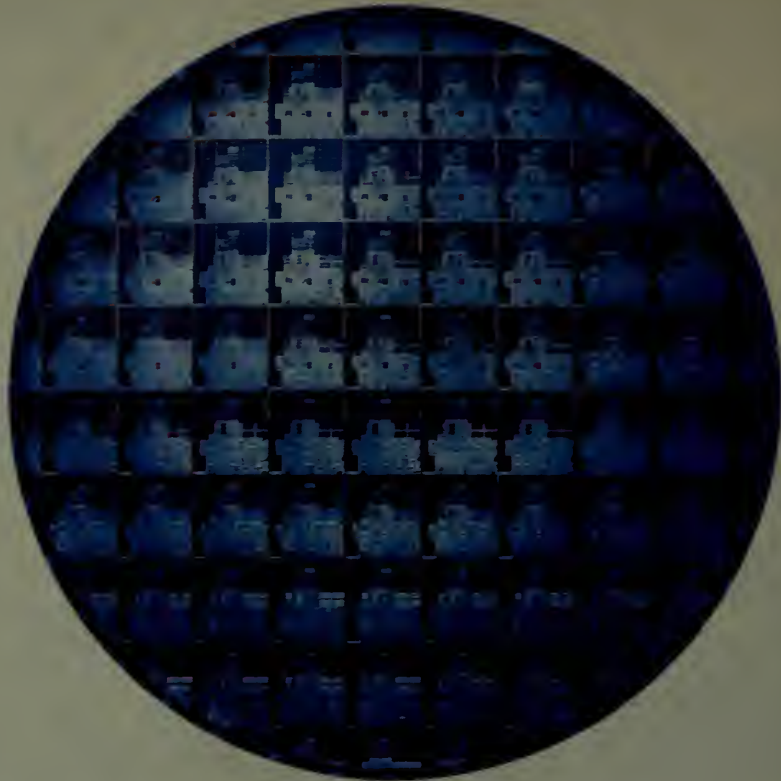
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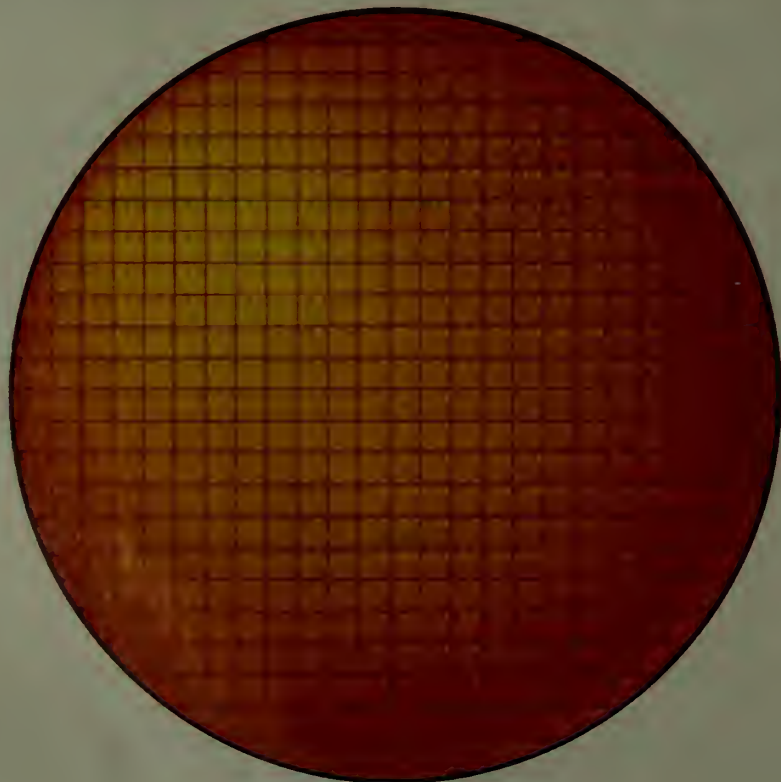
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RAJAT GUPTA,
McKINSEY CEO
SINCE 1994,
VASTLY EXPANDED
THE FIRM

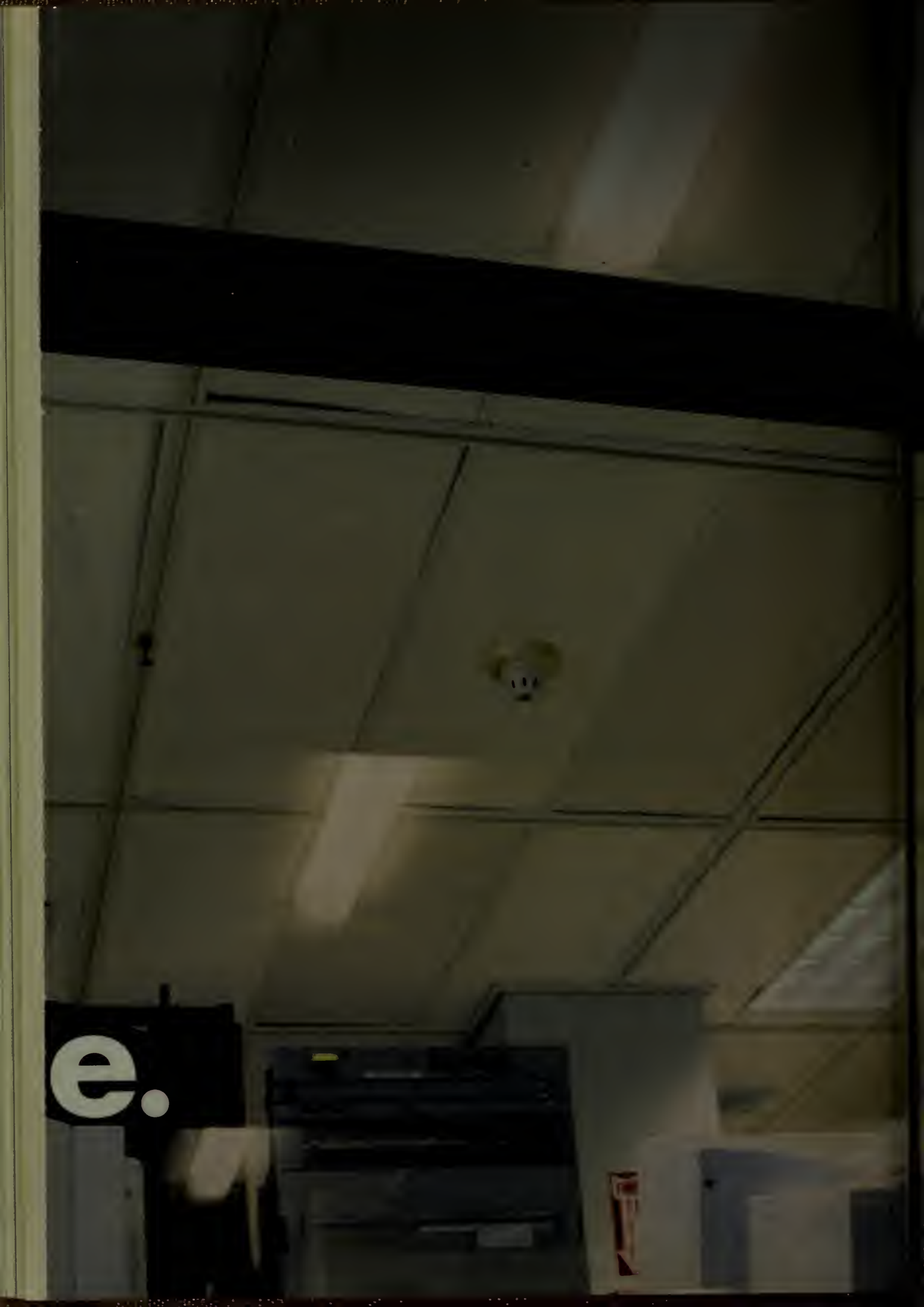
It's the world's most prestigious consulting firm. But it helped create Enron's high-risk business model. And some of McKinsey's other clients haven't fared so well, either: Kmart, Swissair, and Global Crossing.

What's happening?

By JOHN A. BYRNE PAGE 66

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e.

A photograph of a ceiling with a grid pattern. A circular light fixture is visible in the center. Below the ceiling, there is a dark structure with the letter 'e.' and some equipment. The image is somewhat blurry and has a yellowish tint.

not here.

Jon Runkle
Managing Director
Investment Banking

A small pharmaceutical wanted
to expand in a big way
(more R&D = more amazing drugs).
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Managing Director
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Marta Ruiz-Cuervo
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(more R&D = more amazing drugs).
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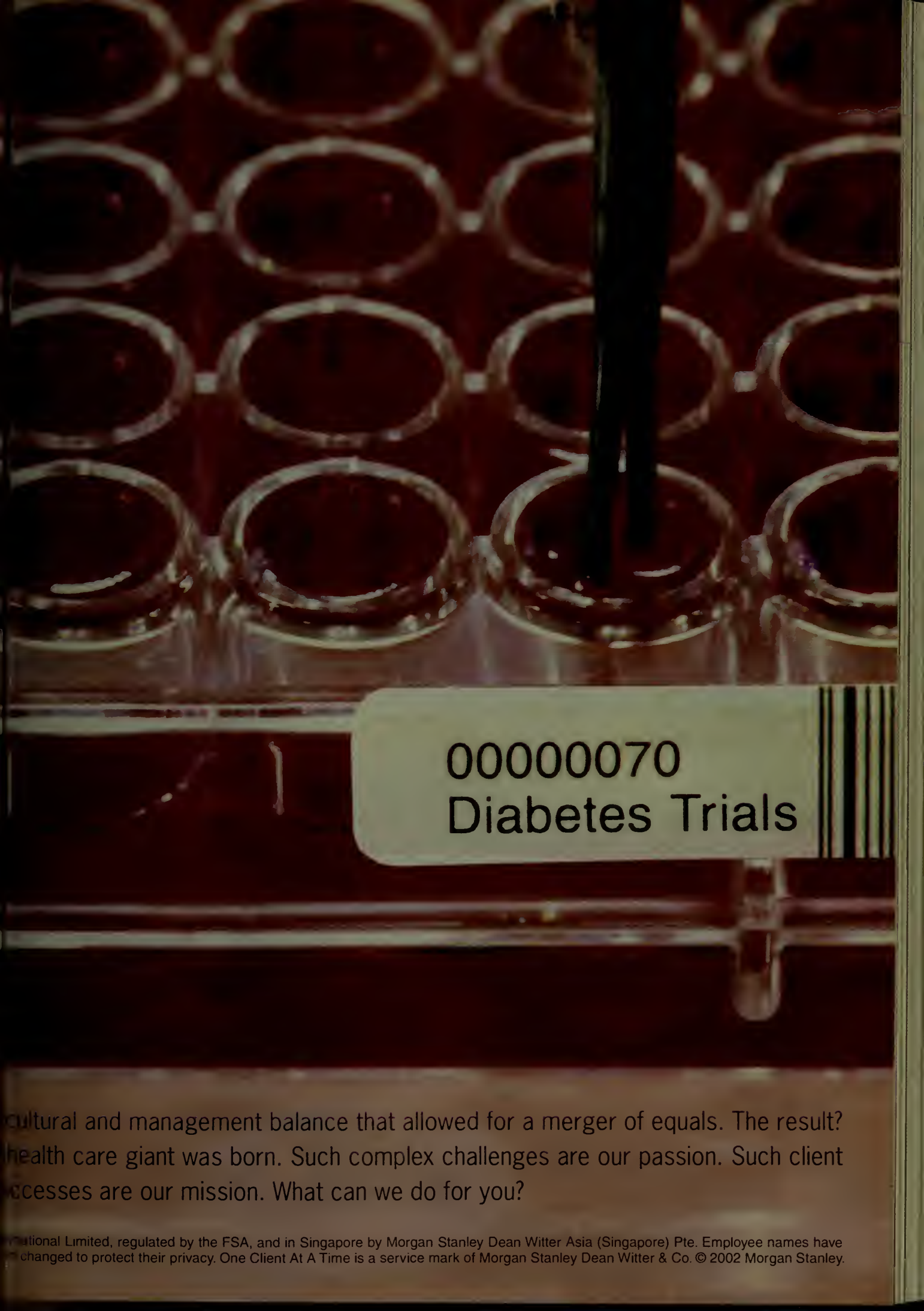
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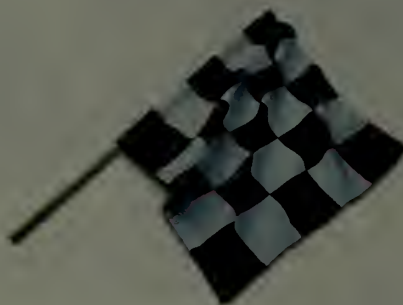


00000070
Diabetes Trials

cultural and management balance that allowed for a merger of equals. The result? health care giant was born. Such complex challenges are our passion. Such client successes are our mission. What can we do for you?

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THE FINISH LINE?



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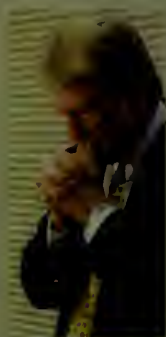
consecutive years. Two courageous moments. One champion. With trophies in hand from the American Le Mans
and the 24 Hours of Le Mans, we could have called it a dramatic finish. But it's just the beginning. This year, we
return to the track. Refining the world-beating Audi R8 racecars. Defending our titles. And challenging the limits of
technology and sports. Because we're not just competing against other teams. We're competing against ourselves.
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COVER STORY

INSIDE MCKINSEY

Enron isn't its only big client to melt down. Suddenly, times are trying for the elite consultant

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RIPPLE EFFECT

The fall of WorldCom rattles all of telecom

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The world's most prestigious consulting firm helped create Enron's high-risk business model. Some of McKinsey's other clients haven't fared so well, either: Kmart, Swissair, and Global Crossing. And those are just the biggest. Now, the meltdown of so many clients is raising some uncomfortable questions. Did McKinsey's partners, caught up in the euphoria of the late '90s, suffer lapses in judgment? Did the firm stray from its core values? And what accountability does it have for the ideas it brings to a company?

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Bankruptcy is looking inevitable. And the company's woes could spell trouble for weak rivals as lenders call in loans to other providers

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The message from shareholders: The house that Messier built has a radical need of restructuring

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With financial services in a downturn, CEO Tom Glozier must reduce the company's dependence on the securities industry

54 COMMENTARY: JAPAN'S BUBBLE

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Venezuela: With the opposition plotting legal maneuvers to oust him, Chávez could be gone

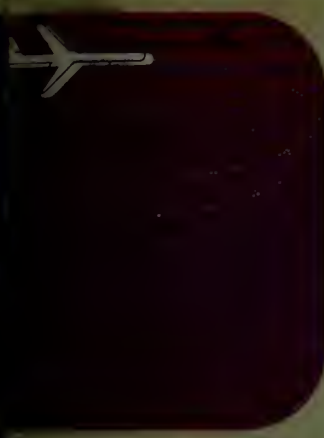
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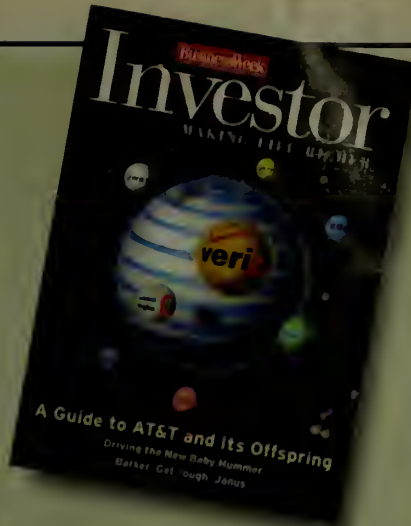
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Industrial Excellence



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money: Is it the end—or the
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COMES ABBY
Abigail Johnson, the third
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rate notebooks, bulky and with
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Vivendi's embattled CEO talks with BW's Steve Shepard about his company's—and his own—woes



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Asian Leaders

At a time of transition in Asia, BW correspondents and editors spotlight 25 individuals who reflect the region's renewed sense of possibility and competitive zeal



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Street Wise: Disney could turn around—especially if a consumer-led recovery does pick up



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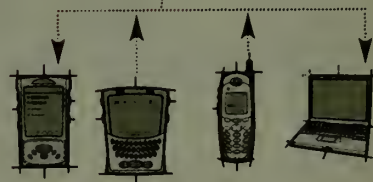


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Up Front

EDITED BY
SHERIDAN PRASSO



SPORTS BIZ

GIVING WOMEN A BACKHAND

FANS STILL SHOW UP IN proper tennis whites. Concession stands dish up strawberries and cream. Ah, Wimbledon, a trip to another era. Including, it seems, its prize money. While the men's singles champ will take home

\$756,000, for women it's another story. At the tournament's end on July 7, she'll get \$700,000, according to the All England Club, the private society that stages Wimbledon.

Wimbledon and the French Open are the only two unequal payers among the four majors. The Australian Open balanced its prizes this year. The U.S.

TALK SHOW "That might not be a bad thing. We don't these people reproducing."

—Mark Haines, host of CNBC's *Squawk Box*, on news that 11% of CEOs say golf is more important than

SERENA: Open did so 30 years ago.

Not as good as a man? Yet it's women's tennis that's hot. U.S.

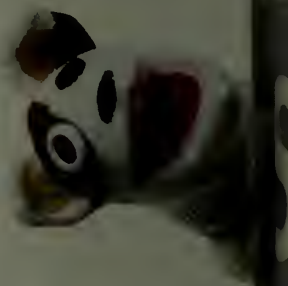
Open officials are even discussing a first—moving this year's women's final to prime time TV. That follows a Serena vs. Venus final at the French Open that pulled in twice the viewers of the men's title match, even though NBC ran the showdown on a two-hour delay.

Says Donna Lopiano, executive director of the Women's Sports Foundation: "I'd say they're just a bunch of stubborn old guys over there." *Mark Hyman*

AFTERLIVES

SOCKING IT TO 'EM ONCE AGAIN

HE'S BA-A-A-ACK. THE Puppet, the wisecrack pitch-critter thrown work when pet-supplier Pets.com went bust



found a new job—pitching loans to people with credit.

He's getting a six-figure for the gig, according to his agent, Brian H. whose licensing outfit got the rights to the famous cot and has licensed the 1-800-bar-none, a loan company in Pleasanton, Calif. connection: The hound knows that every deserves a second chance. "He's a lot like our customers—good people who get into bad times," says company's ceo, Jim Cro

The ads may just be the beginning of a comeback. Hakan is talking to a Hollywood producer about a Puppet sitcom. Don't worry. At least one casualty of the dot-com bust is getting on his feet...oh, wait. He doesn't have any. *Ro*

TREND WATCH

HOW TO GIVE YOUR CAREER A LIFT

THERE'S A NEW PHENOMENON gaining momentum in the corporate world: the elevator speech. Self-help gurus advise that in these downsizing times, those who want to stand out should have a 15-second self-promo speech at the ready, just in case they find themselves unexpectedly face-to-face with the boss.

The extemporaneous sound bites, once used by entrepreneurs to pitch startups should they run into a venture capitalist, have now caught on outside Silicon Valley. And not just in elevators: also at job interviews, networking events, and with people and companies pitching ideas or

products. Even singles are coming up with 15 seconds of catchy self-expression.

Corporate trainers report a surge in interest. Craig Harrison, a Berkeley (Calif.) motivational speaker, has seen demand for his elevator-speech seminars jump 35% in the past year. He advises people to hit hard on the value of what they do, not just who they are. For example, he suggests a software engineer should say, "Hi, I'm the Claude Monet of software. My masterpieces are



UPWARD MOBILITY: Elevator speech

written with zeros and ones" before introducing himself.

It does get attention. Then again, maybe not the kind you want. *Andrew Heller*

THE LIST SAY CHEESE—DIGITALLY

Digital camera sales are heating up. This year's top sellers, ranked by researchers N

CAMERA



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HP PHOTOSMART 318



OLYMPUS C-3020



SONY DSC-P50



SONY MVC-F075



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Up Front

VACATION NATION

NOT YOUR FATHER'S WINNEBAGO

WITH AMERICANS CUTTING back on flying, it seems they're turning to comfy road travel instead.

Recreational vehicles are hot, with sales and rentals

more," says Larry Johnson, sales manager at Palm RV Centers in Fort Lauderdale. Sales at his dealership are up 25% over last year, to \$2 million. A leading RV manufacturer, Monaco Coach, says it has seen a surge in better-performing diesel RVs in the \$150,000 to \$200,000 range.

The buyers—mostly baby boomers—seem to want it all. Besides icemakers and washer-dryers, consumers are asking for convection and microwave ovens, computer workstations, and even surround-sound CD systems and satellite dishes.

And if they get to feeling claustrophobic? No problem: Among the most popular features

are movable walls that allow users to open up the vehicle and expand the space once the motor home is parked. *Aixa M. Pascual*



ALL SET: For land, sea, cyberspace

booming. RV sales nationwide are up 20% over last year, and manufacturers are seeing a huge backlog in orders this year. "I wish I'd ordered

BOARDS WITH BITE

HOW TO PINCH A CEO'S PAYCHECK

ONE WAY TO GET CEO PAY under control? Make sure the boss knows he's being watched by someone who owns a good chunk of the company stock. A recent study examined the CEO pay of 1,648 companies. It found:

12.5% That's the average cut in CEO pay when the amount of stock held by the largest outside shareholder is doubled.

5% That's the average reduction in CEO pay that results from doubling the stock held by the board's compensation committee.

"Once the board becomes a stakeholder in the firm, rising CEO compensation starts to personally pinch the board members," says study co-author Praveen Kumar of the University of Houston. "Worst-

off are going to be firms with no directors with shareholding stakes. Their CEOs feel relatively unconstrained."

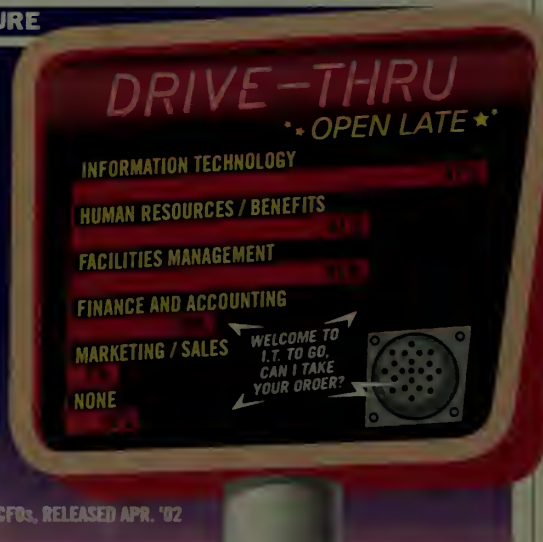
Kimberly Weisul

THE BIG PICTURE

OUT FROM THE SOURCE

About 90% of CFOs report outsourcing nonessential business operations to specialized companies. The top five categories:

ONLINE SURVEY OF 521 CFOs, RELEASED APR. '02
Data: Hewitt Associates



DRAWN & QUARTERED



PIRACY PATROL

UPPING THE PRICE OF DOWNLOADING

THE MUSIC BIZ MAY SOON GAIN an unlikely ally in its crusade against piracy: the cable guy. Several cable companies, including AT&T Broadband, Charter Communications, and Cox Communications, are moving away from old fixed-rate pricing plans that allowed users to download endless data.

Instead, they're replacing them with limited billing options that could end up curbing how much time users spend swapping files on Napster successors such as KaZaa and Morpheus and result in fewer songs available

for download. That mean less illegal copy-

One new pricing plan considered by charges for overtime, to the way cell-phone companies bill customers for exceeding monthly time. Another plan that Charter has used for two years: modem speed: The faster download, the more you pay.

At an age of \$45 a month, broadband is perceived as too expensive by many consumers. Subscriber growth slowed to 12% in the first quarter of 2002, the worst on record.

So cable companies plan to lower the cost of broadband access plans, little as \$25, then charge users more for faster time or faster loads. Currently, AT&T's customers pay 16% of its bandwidth yet pay the same rate as occasional users.

Many of those avid music downloaders. And that's why the entertainment industry is excited about any potential disincentives. Says Cohen, vice-president of new media at record EMI: "Tiered pricing will help artists or labels get paid, but it's a step in the right direction." *Jane I.*



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MIKE WHOLLEY
REGIONAL VP, EASTERN DIVISION

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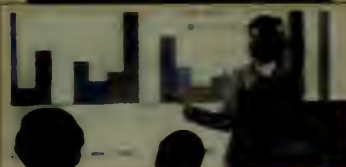
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UNCOVERING THE SHENANIGANS

In business journalism, there is no higher honor than the Gerald Loeb Award for Distinguished Business and Financial Journalism, presented by the Anderson School at the University of California at Los Angeles. We're pleased to report that *BusinessWeek* Associate Editors David Henry and Nanette Byrnes are 2002 Loeb Award winners for magazines. Their pair of cover stories, "The numbers game" and "Confused about earnings?" jump-started calls for the very accounting reforms that are being debated today.

ON THE CASE: Henry and Byrnes



BusinessWeek readers were on to accounting shenanigans long before Enron Corp. launched this year's explosion of scandals. "The numbers game" (May 14, 2001) was the result of an examination by Henry of dozens of corporate financial statements. He exposed pro forma and other accounting gimmicks that could pad earnings and deceive investors, naming 34 companies in the process. On Nov. 26, Byrnes and Henry teamed up on an advocacy piece, "Confused about earnings?" They charged that the pro forma legacy of the dot-com boom accelerated a nasty trend: companies making up their own ways to calculate earnings

until they find one that shows profits. Byrnes and Henry provided road map for financial statement. And they proposed rules for calculating operating earnings and a requirement to make clear how they re-

late to net income.

Accounting sleuths Henry and Byrnes continue on the case, along with Senior Correspondent Mike McNamee in Washington (who contributed to the Nov. 26 cover); Senior Editors Mary Kuntz and John Templeman (who oversaw much of this coverage); and correspondents throughout our bureau system.

Pleased as we are with *BusinessWeek*'s Loeb Award winners, the winners are you, our readers.

Stephen B. Shepard

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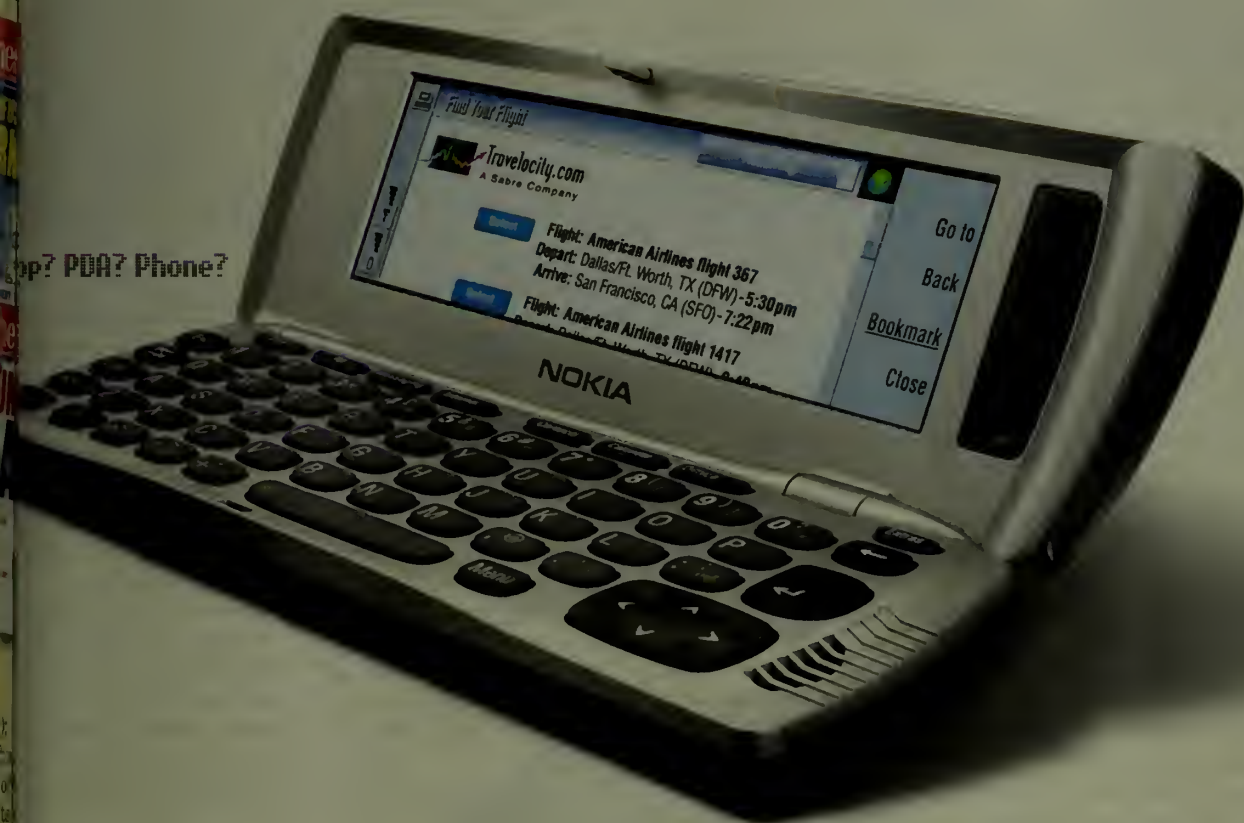
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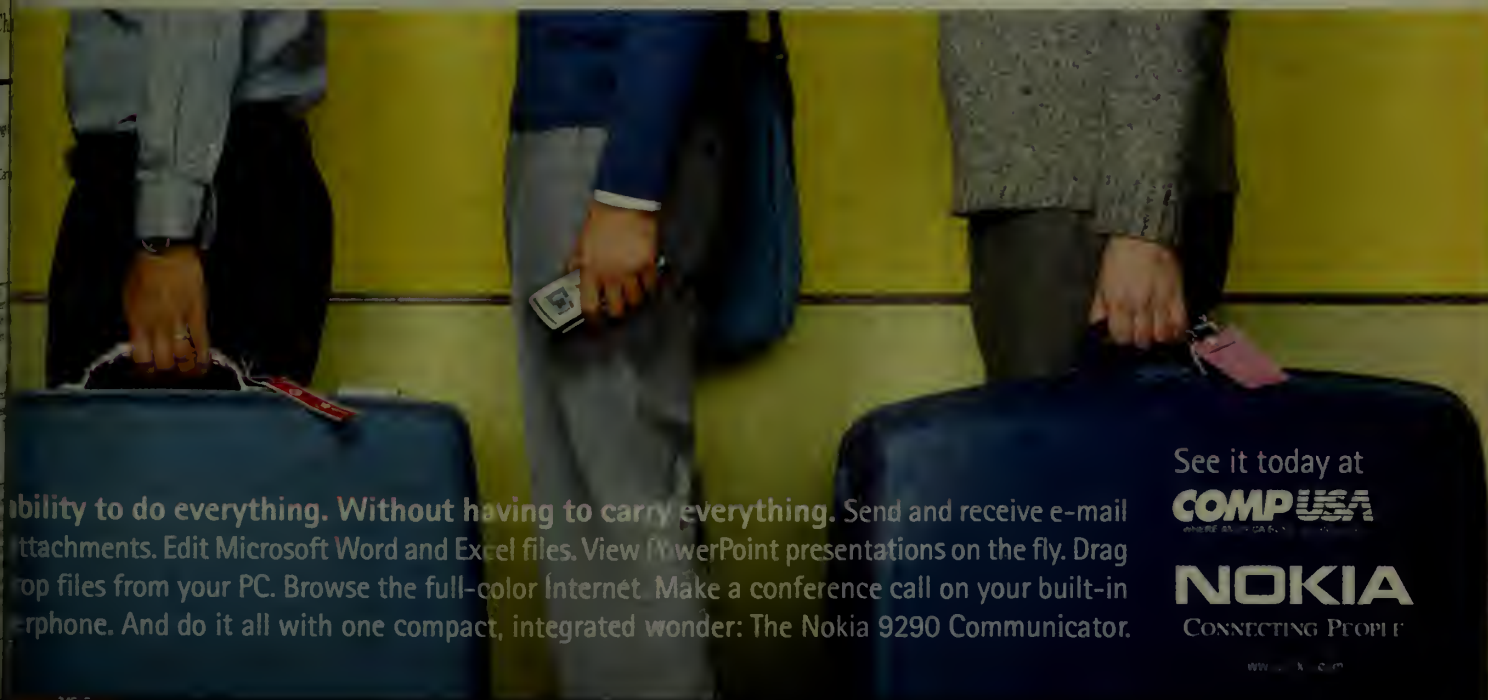
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Readers Report

AIG AND STARR INSURANCE: WHAT'S BEST FOR SHAREHOLDERS

Corporate directors and officers have a fundamental obligation to do what is in the best long-term interests of their shareholders. While this simple precept is at the heart of the current debate over corporate governance, Louis Lavelle missed this essential point in his commentary when he made reference to American International Group Inc.'s 50-year relationship with the Starr Insurance agencies ("When directors join CEOs at the trough," Management, June 17).

The history and facts behind this relationship, which we shared in depth with Lavelle before he wrote his piece, tell an exemplary story of how shareholders' interests were put ahead of directors' and management's. The Starr managing general agencies benefit AIG and its shareholders by generating attractive business for AIG subsidiaries. AIG companies pay commissions to the Starr agencies at rates no greater than those paid to unaffiliated producers for comparable business.

Although these agencies were part of the original operations of AIG's founders, they were not sold to AIG with other Starr assets over 30 years ago after AIG went public, because they were small and not profitable at the time, and management did not want to saddle AIG with money-losing operations. AIG has done what is best for its shareholders, which is the essence of good corporate governance.

Maurice R. Greenberg
Chairman
American International Group
New York

DON'T CONFUSE CONVERSATION AND CONCERTED ACTION

"Big guns aim for change" ("Restoring trust in Corporate America," Cover Story, June 24) correctly points out our firm's strong interest in improving the corrupt system of executive compensation that plagues much of Corporate America. While our firm has spoken with other like-minded institutional investors and experts including Bill Miller, Warren E. Buffett, and John C. Bogle about this issue, at no time during our conversations with them did they ever agree to "sign up" as a group, as your article implies.

While I believe that the formation of a group of reform-minded institutional investors could serve to advance the cause of corporate governance, and

while I am certainly interested in speaking with other institutional investors who feel the same way, your article was mistaken in implying that our firm has created such a group.

Christopher C. Davis
Portfolio Manager
Davis Selected Advisers
New York

WHY ONE INVESTOR OPTED OUT OF THE STOCK MARKET

The reasons given in "Investors are ignoring all the good news" (Business Outlook, June 17) fail to include what should be the most obvious: Flip the page to "What Cleanup?" (News: Analysis & Commentary, June 17). Independent investors like me have opted out of the stock market. There is no serious reform drive in Washington (Securities & Exchange Commission Chairman Harvey L. Pitt apparently even secretly meets with suspect firms!), and CEOs still reap outrageous salaries, bonuses, and stock options all the while steering their companies to record losses.

Come on. Should I be so stupid as to continue to finance such shenanigans? I'm out for as long as the system remains unchecked. Good luck to Warren Buffett and John Bogle in their attempt to get rightful action for the investor.

Norman James
Pittsburgh

MICROSOFT: MAKING BUSINESS MORE COMPLICATED?

Finally the truth comes out in your profile of Microsoft Corp. CEO Steve Ballmer ("Ballmer's Microsoft," Cover Story, June 17). Ballmer's own words reveal what many have thought for years, that Microsoft's real business strategy is to complicate the operations of its customers and then sell them the solutions to fix those very snafus.

"If we're successful," he says, "business isn't going to be any simpler to run five years from now than it is today. We better be thinking about the tools we need to run that business now." Brace yourselves: Here comes a whole new generation of "innovations."

Charlie Fletcher
Columbia, Ky.

DEMOCRACY GIVES THE BEST A HEALTHY OUTLET

While terrorists may be better off than their peers, as Robert J. Barro says, it's a long way from refuting the

CORRECTIONS & CLARIFICATIONS

Sterling Financial Investment Group do not take short positions in stocks (BusinessWeek Investor, July 1 in some editions).

"A genome project against disease" (Science & Technology, July 1) misspelled Clifford Fraser's name in a sub-headline and

"The danger of playing it safe" (Economics, June 24) gave an incorrect first name to Friedrich Engels, co-author with Karl Marx of *The Communist Manifesto*. Also, the manifesto was published in 1848, not 1849.

power of economic advancement myth that poverty breeds terrorism (Economic Viewpoint, June 10). If free markets and democratic governments help countries improve by providing a healthy path for intelligent, success-driven individuals. The brightest have a system that allows them to amass power and money in a way that advances society.

On the other hand, terrorism is at its worst in countries that lack free markets and democratic government. These countries' best and brightest people strive for success and power, but instead of building businesses, they devote their time toward leading through nationalistic radical cells.

Bob Gilman
Cincinnati

WHAT ARE STATE SECURITIES REGULATORS REALLY DOING?

"The Street's new cleanup" (News: Analysis & Commentary, June 10) says that "states formed a task force to tackle the analyst issue, one of the first tasks was coming up with a formula for divvying up the proceeds from... settlements." Why does this sound like racketeering to me?

Thomas J. Lawrence

DECONSTRUCTING CHINA'S WTO PARTICIPATION

Some interesting facts could have been added to Jeffrey E. Garten's column. "When everything is made in China" (Economic Viewpoint, June 17). China has three votes in the World Trade Organization, and every other nation has one. Hong Kong has a vote that it received prior to becoming part of China. Taiwan joined with status of a "observer."



Way back in the late nineteenth century, Jules Verne, that master of science fiction, foresaw many of the technological wonders that are commonplace today. Yet, as far-reaching as Mr. Verne's imagination was, even he would be amazed at the many marvels there are to be found in the Lexus ES 300.

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rate customs territory"; and China itself has a vote.

Chinese companies are building free-trade ports and foreign trade zones in the Caribbean. They are also in Mexico. By using this system, the Chinese companies can get around the tariffs, duties, and quotas.

In reality, very little trade actually takes place between an exporter and importer. The beneficiaries seem to be the multinational companies and category-killers, which can purchase directly from manufacturers.

Peter T. Milne
Toronto

China has more incentives to act responsibly and sensibly in world affairs because its economy is entangled in the global economy. In fact, China's relations with the rest of the world, including its neighbors as well as the U.S. and Western countries, are more productive, stable, and less confrontational than ever before.

Qiming Han
Hamden, Conn.

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THE GREAT 401(K) HOAX

Why Your Family's Financial Security

Is at Risk, and What You Can Do about It

By William Wolman and Anne Colamosca

Perseus • 246pp • \$26

PENSION PLUNGE

What horrified some people most about the Enron Corp. collapse was the way its employees' retirement accounts got wiped out. The increasingly popular 401(k) is a pension plan in which employees are responsible for investing a tax-sheltered portion of their earnings and employers kick in matching funds or stock. In the booming 1990s, millions came to see their 401(k) plans as perpetual wealth-spinners.

They're anything but, say former *BusinessWeek* chief economist William Wolman and Anne Colamosca in *The Great 401(k) Hoax*. They argue that Americans have been hoodwinked by corporations and Wall Street into believing that investing savings in stocks will guarantee income enough for

a comfortable retirement. But by the end of the '90s, a decade of stock prices quintupled, the average 401(k) account held just \$46,700.

Worse, the authors say, there is evidence that stock market returns probably average less than 2% throughout the first decade of the 21st century. They draw parallels to the bubbles that peaked in 1901, 1929, 1966 and were followed by years of declining or stagnating stock prices.

Along the way, they explain why employers wiggled out of legal commitments to provide pensions on defined benefits in favor of

contributions—the essential flaw in the 401(k) system. And they skewer Democrats and Republicans for policies that encourage Americans to become hooked on the stock market.

What to do? Many authors will contribute only modest plans, and Congress can't seem to agree on even modest

forms. Wolman and Colamosca urge investors to load up on high-quality stocks and bonds, particularly U.S. Treasuries whose yields are increasing in inflation, and shut out the "noise" of Wall Street's ever-optimistic price speculators. The go-go years are gone.

KING OF CAPITAL

Sandy Weill and the Making of Citigroup

By Amey Stone and Mike Brewster

Wiley • 306pp • \$24.95

CITI PLANNER

When Travelers Group Inc. merged with Citicorp in 1998, the result was a sea change in the financial world—or as *BusinessWeek* dubbed it at the time, "Weill Street." The architect of the merger, Sanford I. Weill, is the subject of *King of Capital* by Amey Stone, a staff editor at *BusinessWeek* Online, and journalist Mike Brewster. This is a rags-to-riches-to-greater-riches story, recounting Weill's rise from a middle-class Brooklyn boyhood to primacy on Wall Street.

The book focuses on Weill as a dealmaker, and there is plenty of grist for that. Weill got his start in 1960, as a partner in the small brokerage firm of Carter, Berlind, Potoma & Weill. The firm grew steadily and in 1970 acquired the troubled retail brokerage Hayden, Stone & Co. The acquisition was the prototype for the many deals that would follow. Four years later, the merged firm bought an-

other financially strapped outfit, the son Hamill. The result was Salomon Brothers, Wall Street's second-largest brokerage—followed by Weill's biggest mistake, the acquisition of Shearson to American Express.

The 1981 Shearson-American merger seemed on the surface a

good idea. "The truth is that it would have been crazy not to join the deal," say the authors. But it turned out to be a hard marriage. There were strains from the very start, and

Weill had a tough time playing second fiddle to American Express Chairman

and executive James D. Robinson. Weill left the company in 1988 and

bought a struggling Baltimore firm called Colonial Credit Co. Then he made an impressive comeback

in Primerica in 1988, buying back Shearson from American Express in 1993, and making

the grand move, the Travelers buyout of Salomon Brothers.

With the subsequent purchase of Salomon Brothers, Weill was back where he was before he signed his ill-fated American Express deal—and then some.

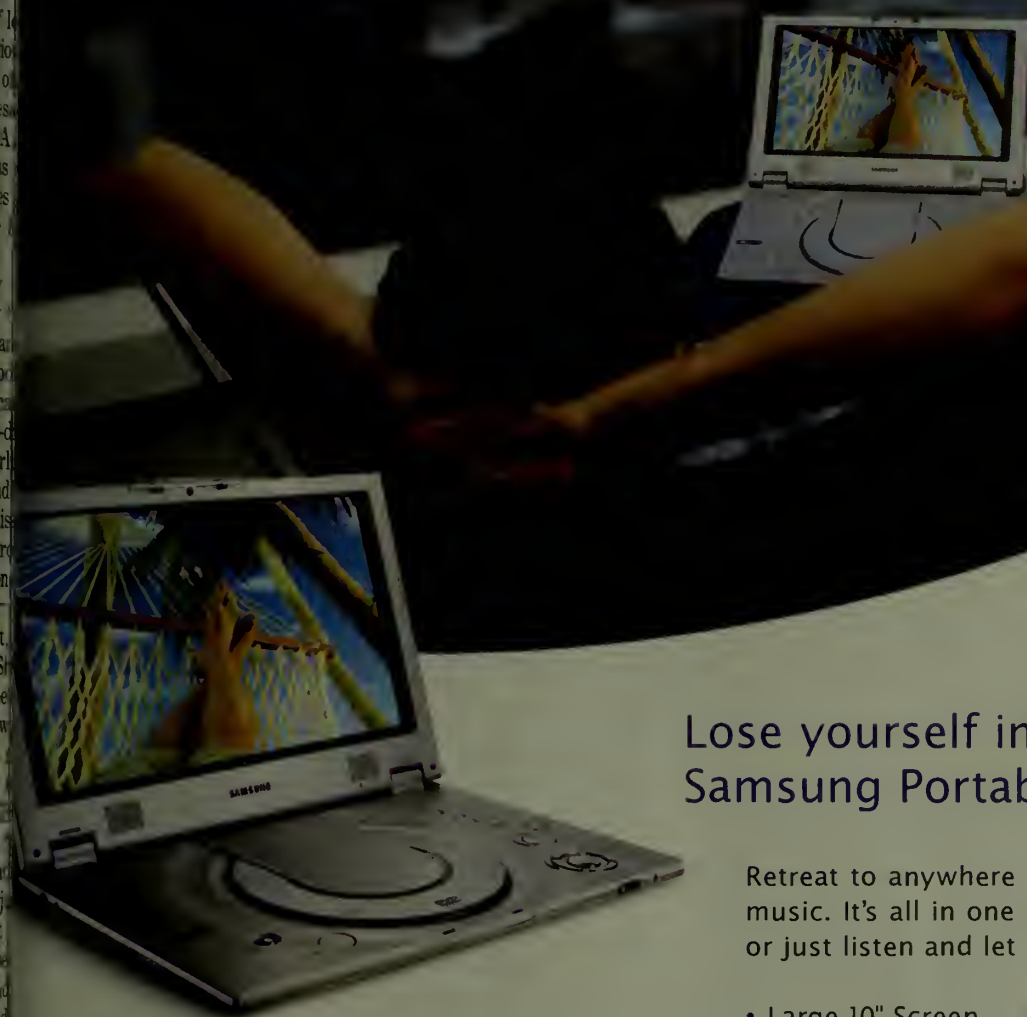
As a result of the Citigroup merger, the "migrants" kid from Brooklyn was

top of the heap on Wall Street.



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THE RUSSIA HAND
A Memoir of Presidential Diplomacy
By Strobe Talbott
Random House • 478pp • \$29.95

DID BILL FORGIVE BORIS TOO MUCH?

Boris Yeltsin is in his underwear, roaring drunk, demanding pizza. He's spending the night at Blair House, the stately Lafayette Park guest quarters for foreign leaders visiting Washington. It's the fall of 1994, and Yeltsin, Russia's first post-Soviet President, has come to meet with Bill Clinton to discuss the future of NATO. Clinton was never much bothered by such episodes—and there were many involving Yeltsin. “At least Yeltsin's not a mean drunk,” Clinton tells Strobe Talbott, his top adviser on Russia and a friend from their days as Rhodes Scholars and housemates at Oxford University in the late 1960s.

Clinton has a point, but Deputy Secretary of State Talbott is appalled anyway. And he's disturbed by Clinton's “indulgence of Yeltsin's misbehavior,” as he writes in *The Russia Hand*, his perceptive, if a bit self-justifying, memoir of his Clinton Administration days. A savvy insider's account of the diplomatic twists and turns of U.S.-Russia relations in the '90s, Talbott's anecdote-stuffed book is a treasure trove for Russia specialists. But it will also fascinate anyone with an interest in the personal dynamics of statecraft. An ex-*Time* magazine Washington bureau chief who specialized in writing about White House-Kremlin brinkmanship during the Cold War, Talbott sees Clinton and Yeltsin as a curious and rather worrisome pair of psychological twins.

After all, both dipsomaniac Yeltsin and alley cat Clinton could be said to be in thrall to obsessions that occasionally sent them reeling. “I suspected there was more to his affinity with Yeltsin than being approximately the same height and shape and shoe size, or being the leaders of two countries that could blow up the world, or being fellow politicians who had to contend with obstreperous legislatures and hostile me-

dia,” Talbott observes. “The key, as I saw it, might be that Yeltsin combined prodigious determination and fortitude with grotesque indiscipline and a kind of genius for self-abasement. He was both a very big man and a very bad boy, a natural leader and an incurable screwup. All this Clinton recognized, found easy to forgive, and wanted others to join him in forgiving.”

The question is whether Clinton forgave too much. True, when he was first elected President, in November, 1992, there were compelling reasons for hinging his Russia policy on Yeltsin. At that time, Yeltsin was a popular figure with ordinary citizens but was hated by Communist Party leaders—who blamed him for the Soviet Union's crack-up and opposed his pro-market reforms. “I get the feeling he's up to his ass in alligators,” Clinton tells Talbott shortly after the election. “We've got to try to keep Yeltsin going.”

In gaining Yeltsin's trust, partly through U.S.-championed credits for Russia from the International Monetary Fund, Clinton smoothed the path for important U.S. policy accomplishments, such as the expansion of NATO to include Poland, Hungary, and the Czech Republic. On that, Yeltsin resisted powerful opposition from his own generals to strike a deal with Clinton.

Nevertheless, along the way Yeltsin deteriorated badly. As his bouts of drinking and depression worsened, inflaming insecurities that led to baffling shakeups of his Kremlin team, his political star plummeted. The very people who in 1991 had applauded his heroic stance against KGB coup plotters came to see “Czar Boris” as a national embarrassment. Average citizens sensed, cor-

rectly, that Yeltsin, also sapped by disease, had lost control of the state. The real stewards were a band of Big Business titans—called oligarchs—to whom the dispensensed massive state property the cheap in return for their bank of Yeltsin's 1996 reelection. Yeltsin was no longer the cure to Russia's ills but a key feature of its ail-

Talbott, by his own telling, was to the dangers of the oligarchs but no better alternative to continued House backing for Yeltsin. But even by his friend's charitable account comes off as seriously deluded. Russia's financial crisis in August, he tells aides: “I've got to convince [Yeltsin] that for the next two he's got to come to work every day be a bureaucrat and make the government work.” But at that point, Yeltsin was already a political corpse. Wounded by his own gathering scandal over Monica Lewinsky, Clinton may have felt compelled to stand by a fellow suzerain. Nevertheless, the imagined powers of rotation of Yeltsin come off as political narcissism.

Yeltsin seems to have been understood more clearly than was finished. He turned his presidential powers over to Vladimir Putin on New Year's Eve, 1999—a sum move that protected Yeltsin and his members from prosecution over criminal scandals and assured Putin's election victory just three months later. cool Putin's first move was to stiffen duck Clinton on the latter's bid for deal on national missile defense. Clinton searched for a way to manage as he had Yeltsin, but came up empty.

Now, Clinton's successor, George W. Bush, has forged what appears to be a tight bond with Putin. So Bush needs to take care that he himself doesn't come overly committed, as Putin did when he came down on press freedom even while pursuing an economically liberal course. The guess is that Bush, a better-groomed character than Clinton, will do better. Let's hope so: U.S.-Russia relations are tough enough without the complication of psychologically handicapped leadership.

BY PAUL STAROBIN

Starobin is Moscow bureau chief.



TALBOTT SEES CLINTON AND YELTSIN AS A WORRISOME PAIR OF PSYCHOLOGICAL TWINS

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BY STEPHEN H. WILDSTROM

tech&you@businessweek.com

COULD A NOTEBOOK BE BEST FOR YOUR DESK?



These cut-rate computers aren't very portable, but they can be stashed in a drawer

Ever since Compaq Computer brought out the first notebook PC in the late 1980s, the goal of the design has been mobility. And the demand for mobility continues to drive a notebook market that now features powerful PCs that weigh under 3 lb. and are less than an inch thick. But one of the fastest-growing segments of the notebook industry today consists of products that seem to defy all historical trends. They're big and heavy and offer short battery life, often under two hours.

The secret of these products is that they are mobile in name only. Generally, buyers who choose them are looking for a computer that will spend most of its time living on a desktop but can be closed and tucked away when not in use. Portability is a bonus, not a driving force. Recently, designers of these laptops have gone the logical next step and substituted a Pentium 4 processor designed for desktops for the substantially more expensive Pentium 4-M chip designed for notebook use. Industry sources say using the desktop chip knocks about \$100 off the cost of materials, though recent Intel price cuts have narrowed the gap.

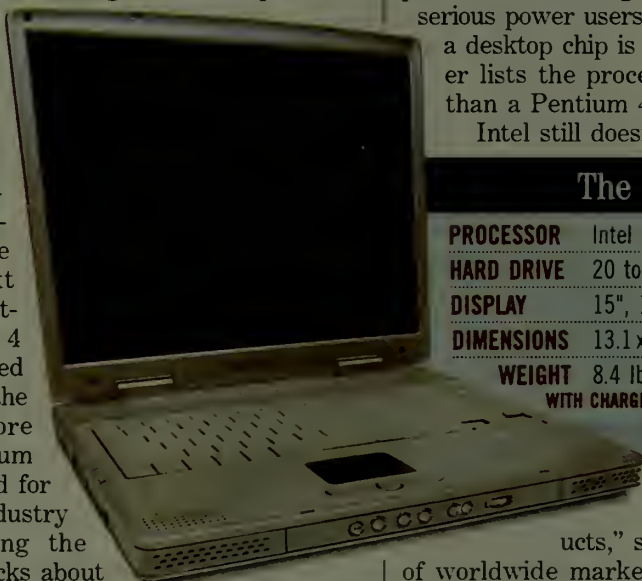
This means that the retail cost of a laptop using the desktop Pentium 4 is likely to be \$150 to \$200 less than a similar product using a mobile chip. The WinBook J4 I tested starts at \$1,599, including a high-resolution 15-in. display. There is a price to be paid, though. The desktop chips lack the circuitry that reduces the power consumption and heat output of the chips designed for laptops.

The short battery life of these mostly stationary notebooks is not a huge issue. The WinBook achieves decent battery life of about three hours by using a massive 23 oz. battery. But getting the heat out of the tight confines of a laptop's case is a major engineering challenge. At 45 watts, the desktop Pentium 4 generates

about 50% more heat than the mobile. Keeping the insides of the notebook from heating requires lots of cooling. The fans in the WinBook, including a unit with a diameter about 2½-in. located just above the keyboard, make the J4 a lot noisier than most laptops, though still quieter than a typical desktop. Also not a laptop you'll want to use on your lap. Between the weight and the toasty bottom of the case, resting it on your knees quickly comes unpleasant.

Some relatively obscure Asian and European laptop makers started the notebook Pentium trend about a year ago. At the time, Intel was not yet making a mobile version of the Pentium 4, and the performance gap between desktop and portable had grown to the widest point in recent years. Intel, which gets much healthier margins on the mobile chips than on their desktop counterparts, tried to discourage the practice. But the company failed to stop Toshiba from becoming the first top-tier manufacturer to introduce a laptop with a desktop processor. Now every major maker of notebooks either offers such models or plans to introduce them. Choices range from sub-\$1,500 models to \$3,000-plus machines designed to appeal to gamers and serious power users. When shopping, the salesperson's advice is that the "Intel Inside" logo lists the processor as a Pentium 4 rather than a Pentium 4-M.

Intel still doesn't like the practice. "I



The WinBook J4

PROCESSOR	Intel Desktop Pentium 4, 1.7-2.4 GHz
HARD DRIVE	20 to 40 GB
DISPLAY	15", 1400 x 1050 pixels
DIMENSIONS	13.1 x 10.8 x 1.8 in.
WEIGHT	8.4 lb.
WITH CHARGER	

Data: WinBook

recommend using desktop processors in mobile products," says Don McDonald, director

of worldwide marketing for Intel's mobile programs. "Realistically, the reason manufacturers are doing it is pricing," McDonald estimates that 20% of consumer notebooks contain desktop processors. "Buyers are less educated about the difference, and they are seeing these products from big brand names." Rival Advanced Micro Devices, whose market share in portable computers is less than in desktops, is more enthusiastic about the practice. "There are applications, like high-end notebooks, that a 45-watt processor is justified for," says Pat Moorhead, vice-president for consumer advocacy.

Are these computers right for you? I would think that lugging a 9-lb.-plus notebook to fit in most briefcases to the office and would get old fast. But if you want a compact hideaway PC for home or a small office, or these desktop-based notebooks could be the thing.

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Peter Bendor-Samuel is CEO of The Everest Group, a Dallas-based consulting firm specializing in outsourcing. He is also the editor of The Outsourcing Journal and The BPO Journal, and is the author of "Turning Lead Into Gold: The Demystification of Outsourcing" (Executive Excellence, 2000). We asked Mr. Bendor-Samuel to explain the new business process outsourcing model and the benefits that it offers to today's business enterprises.

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Topic: BUSINESS PROCESS OUTSOURCING

Q. What is business process outsourcing, and how does it differ from IT outsourcing?

The two terms mean very much what they appear to mean. IT outsourcing is the outsourcing of the technical IT management and maintenance function, whereas business process outsourcing, or BPO for short, is the outsourcing of an entire business process, like accounting, payroll, or logistics. The key distinction between the two is that while IT outsourcing can lower costs and introduce new efficiencies (as well as more advanced technologies), IT outsourcers do not take on the direct responsibility for accomplishing the business results. For example, an IT outsourcer could provide a state-of-the-art accounting system but would not perform the actual accounting.

With BPO, however, the outsourcing firm gains a whole new role. Rather than merely taking over administrative responsibility for a relatively narrow technical function, as IT outsourcers typically do, the business process outsourcer assumes strategic responsibility for the execution of a complete, business-critical function. This step can introduce new efficiencies and cost savings, of course. But it also makes it possible for the outsourcer to deliver a variety of important strategic benefits to its customers.

Q. What kind of strategic value can business process outsourcing promote?

Beyond the cost savings and efficiencies, a central benefit of outsourcing is that it frees up corporate resources, including scarce personnel resources, to focus on the enterprise's core business or competency. As is well known, if business managers have to worry less about non-core functions, they can spend more time concentrating on core functions—that is, on functions that deliver real value to the enterprise.

With traditional IT outsourcing, only a very narrow range of management resources are freed up—principally, the time and energies of senior IT managers. Now, even this much is beneficial to companies that outsource their IT functions, but the strategic value to the enterprise is limited. With the outsourcing of one or more complete business processes, an enterprise begins to release the time and energies of a much larger group of business executives, many of whom play key roles in the company's strategic direction. Freed from much of their day-to-day tactical responsibilities, they can devote more time and attention to matters affecting the enterprise's long-term business results, including corporate positioning, market penetration, and product development.

Q. How is outsourcing going to evolve over the next five years?

The migration of outsourcing from the IT model to the full-fledged

BPO model is still in its infancy. That trend will continue to move over the next five years. Increasingly, though, as companies realize the strategic benefits available from business process outsourcing, they will learn that they can magnify those benefits by leveraging the outsourced processes. By taking a more enterprise-wide view of outsourcing opportunities, companies may even find themselves outsourcing entire departments or business units responsible for multiple, integrated business processes. Indeed, within five years, the very notion of IT outsourcing is likely to be subsumed by the BPO model, so that outsourcing in general will be defined as the outsourcing of business processes.

Q. What should an enterprise look for in a business process outsourcer?

Experience is critical: companies should look for outsourcers who have successfully executed the targeted functions previously. They should also look for stability and dependability—meaning that it is vital for a company considering an outsourcer to demand and check references. Finally, enterprises should look for an outsourcer that can add strategic value beyond the limited parameters of the function being outsourced. For instance, a regional manufacturer that partners with a global outsourcer for its logistics function may be able to secure cost-effective access to world markets that it could not afford to develop on its own.

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BY LAURA D'ANDREA TYSON

TAX CUTS FOR THE RICH ARE EVEN MORE WRONG TODAY



MISTAKE:
As the public recoils at corporate greed, Bush is still pushing huge cuts for the wealthy—and stiffing the poor

This is a moment of national soul-searching. September 11 and the crisis within the business community have Americans reflecting on the dangers of greed and the need for values that reflect more than self-interest. Yet the Bush Administration seems oblivious to the new spirit. It's pushing ahead with enormous tax cuts for the very rich, while depriving poor children of the help they need to get a fair start.

Despite the Administration's protestations to the contrary, the Bush tax cuts are both expensive and biased toward the wealthy. According to a new analysis by Citizens for Tax Justice and the Children's Defense Fund, in 2010 the tax cuts passed by Congress last year will shower \$121 billion in tax relief on the wealthiest 1% of American taxpayers, who will have average incomes of around \$1.5 million. That's more than half of the total tax relief planned for that year. By contrast, the poorest 20% of American taxpayers will receive about 1% of the total relief. On average, the Bush tax cuts will add a paltry \$98 to their discretionary income—clearly not enough for that ticket to the middle class trumpeted by the Bush Administration as a rationale for cutting taxes in the first place.

For most Americans, three-quarters of the Bush tax cuts have already occurred. In contrast, 80% of the cuts for the wealthiest, who already got an average tax reduction of \$12,000 this year, are scheduled to take effect after 2005. Over the decade, these Americans will enjoy an average tax cut of \$342,000 per taxpayer, draining \$500 billion from the federal budget.

What's worse, the cuts come after a quarter-century during which both pretax and aftertax income and wealth have become less equal. According to Kevin Phillips in a disturbing new book on the threats to democracy posed by increasing inequality, *Wealth and Democracy: A Political History of the American Rich*, aftertax incomes for the bottom 60% of Americans declined, with the bottom losing 12%, while aftertax incomes for the top 1% more than doubled between 1977 and 1999.

Some argue that we shouldn't worry about such trends on the grounds that there is a high degree of income mobility in our society. According to this Pollyanna belief, many of this decade's rich are likely to become next decade's poor, and vice versa. But as data in Phillips' book reveal, the facts don't support this argument. Others say that since the wealthiest shoulder the heaviest tax burden, they deserve the most generous tax relief. But their share of the

total tax burden is about 26%, while their share of the Bush tax cuts is more than 50%.

While President Bush waxes eloquent about the need to wage war against terrorism, he is waging a political war to repeal the estate tax, which affects only the wealthiest 2% of households. While the President is urging college graduates to eschew a culture of selfishness and embrace a cause larger than personal profit, he is trying to accelerate tax breaks for the wealthy on the grounds that it is their money.

Children stand to lose the most. During the 2000 Presidential campaign, President Bush embraced the motto of the Children's Defense Fund: "Leave No Child Behind." But his Administration's budgetary choices have consistently left millions of children behind. One out of five children in America, most in working families, is poor during the first three years of life. A majority of American fourth-graders still cannot read or do math at age-appropriate levels of proficiency. And only one of seven eligible children is currently covered by the federal government's block grant program to support quality child care for poor working families.

Yet under the 2003 Bush budget proposal, a single additional child will be enrolled in Head Start despite the fact that the program serves only three in five eligible preschoolers and less than 5% of the infants and toddlers eligible for early Head Start. Bush's 2002 budget proposal provides 40 times more money for tax cuts than for education. Shortly after signing his "No Child Behind" education reform bill, Bush proposed the 2003 budget with the smallest increase in education spending in seven years.

Making the child-care tax credit fully refundable and expanding the earned-income tax credit could lift every poor family with children above the official poverty level at a cost of \$34 billion a year—half the tax cut for the wealthiest when fully phased in. This is a sound investment, because every year a child spends in poverty costs an estimated \$12,000 in lost economic output over his or her lifetime. Every additional dollar invested in quality early childhood care and education saves \$7 by increasing the likelihood that a child will be literate, enrolled in post-secondary education, and employed during his or her lifetime.

Most Americans sense that it's both morally wrong and economically wasteful to heap tax cuts on the rich while skimping on help for families. What will it take for the Bush Administration to get the message?

Laura D'Andrea Tyson is dean of London Business School.

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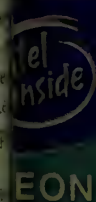
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EDITED BY MICHAEL J. MANDEL

CHINA'S BANG FOR THE BUCK

It will gain from the dollar's fall

The falling dollar could be bad news for many countries that count on the U.S. as a prime export market. A depreciating dollar will make imports more expensive, while U.S. exports to the rest of the world become comparatively cheaper.

Surprisingly, however, the decline in

CHINA'S RISING TRADE SURPLUS



the dollar could greatly benefit China, says Stephen L. Jen, chief currency economist at Morgan Stanley. Since early 1998, China has unofficially pegged its currency, the yuan, to the dollar at an exchange rate of about 8.28 to 1. That means as the dollar has deteriorated against the yen, euro, and other currencies this year, the yuan has declined as well.

The implication: If Beijing continues to tie the yuan to the dollar, a depreciating dollar won't slow U.S. imports from China, says Jen. Nor is it likely to narrow America's trade deficit with China, the largest for the U.S. among its trade partners in 2001.

And riding the depreciation of the dollar, China's exports to the rest of the world will become more competitive as well. After the U.S., China's biggest destinations for its goods and services include Japan, South Korea, and the euro zone. Already, both the Japanese yen and Korean won have climbed better than 8% against the dollar this year, while the euro has gained 10%. The stronger currencies will only add to China's already growing global trade surplus (chart).

Jen forecasts a 20% depreciation in the dollar by the end of 2003. If that is matched by a similar decline in

the yuan, China's improving trade balance might not be the country's only bright spot. More foreign corporations may take advantage of the weakening yuan and already inexpensive cost of labor, sending even more business China's way.

By James Mehring

BONDS MAY BE A ROCKY HARBOR

They're volatile and pricey, too

When bears overrun the stock market, investors traditionally seek safety in bonds. But this time around bonds may not offer the safe haven investors are looking for, says a study by Tobias M. Levkovich, a senior institutional equity strategist at Salomon Smith Barney.

A big fear of equity-shy investors is that all the air still hasn't been squeezed out of the stock market bubble. They note that the Standard & Poor's 500-stock index is trading at 20 times projected 2002 earnings, well above the average multiple of 15.7 that the index has maintained over the past 42 years. That's a 22% premium to the historical average.

Unfortunately for investors, bonds are also trading at a premium, Levkovich notes. Since 1960, the average yield on the 10-year Treasury note has been 7.25%. That makes the current yield of around 4.75% more than one-third below this average.

In part that's because of low inflation. But bond yields respond to more than just inflation, so interest rates could rise even as inflation stays quiet, causing bond prices to plummet. "Investors think they're safe in bonds, but this bond market is not risk-free," says Levkovich. Fears of terrorism, a weakening dollar, and surging U.S. government budget deficits affect bonds at least as much as stocks. Moreover, every day skittish institutional investors are moving large amounts of money back and forth between stocks and bonds. As a result, bond prices have been swinging widely.

This riskiness of bonds, combined with the fears in the equity market, may help explain why money is flowing out of the financial markets and into housing. When both equities and fixed-income investments seem uncertain, the solidity of real estate becomes more and more attractive.

By Margaret Popper

CALL IT THE FIRST-WORLD CUP

Richer countries have a leg up

It's often suggested that football teams in richer cities have an edge. Franchises such as the New York Yankees, bolstered by strong revenue, can afford to pay for better training facilities and the best players, the argument goes.

Something similar could be happening in soccer, where richer countries have a growing advantage. A study by Goldman, Sachs & Co.'s London-based economists notes that in terms of wins, "the more successful nations in Europe and Latin America [are] the most prosperous." The Goldman report also showed some correlation between per capita income and the success of FIFA, the international soccer federation.

Richer countries did seem to have a better showing in this year's World Cup, at least in the earlier rounds. Of the 32 nations in the 2002 tournament, 9 of the biggest 10 economies were in the top 16. Among them were the U.S. and the world's two largest economies. Only recently have begun to field quality teams. By comparison, the 16 of 32 in the 1998 World Cup included only 7 of the biggest 10 economies.

It's difficult for poor countries to attract the best coaches and team talent. Out of the countries that made the round of 16 this year, only Paraguay, Senegal, and Turkey had per-capita income below the global average of \$6,693.

But national wealth, while important, didn't have the final say in how countries fared in this year's contest. The average per capita income of the 16 teams in the round of 16 was \$15,238 (chart). The eight winners in the quarterfinals had an average income of \$15,238. By the time the tournament was down to four, the countries' average was \$12,011. Nevertheless, if rich nations keep improving, it may become harder for poor countries to compete in the World Cup on equal terms.

By Margaret Popper

MORE MONEY EARLY ADVANTAGE

AVERAGE GDP PER CAPITA 2002 WORLD CUP

FINAL 16 COUNTRIES

QUARTERFINALS

SEMIFINALS

THOUSANDS OF DOLLARS

Data: 2002 FIFA World Cup Factbook

MES C. COOPER & KATHLEEN MADIGAN

THE TWIN DEFICITS ARE BACK AND AS DANGEROUS AS EVER

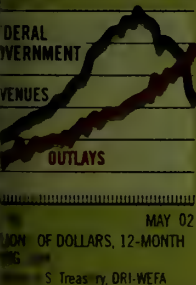
Widening budget and trade gaps could jeopardize growth

U.S. ECONOMY

The twin deficits have returned. A ballooning federal shortfall and a widening trade gap are towering, maelstrom-like, over the nascent recovery. These two threats, if unchecked, could cause trouble for the financial markets, the U.S. dollar, monetary policy, and economic growth.

The U.S. shouldered these twin burdens before. In the mid-1980s, the federal and trade deficits mushroomed, with serious consequences. Interest rates were higher than they should have been, and massive foreign subsidies boosted the dollar to a level that clobbered exporters. Consequently, U.S. businesses had little incentive to invest. Spending on new equipment stalled from the end of 1984 until the start of 1987.

THE BUDGET GAP BALLOONING AGAIN



A similar outcome could spell danger for the economy, which is looking vulnerable right now. New allegations of accounting fraud at WorldCom have further heightened investor uncertainty and pushed stock indexes to new lows for the year (page 36). Consumers are feeling less confident about the recovery and job prospects.

Real gross domestic product have grown at less than a 2% annual rate in the third quarter. And while the Federal Reserve Board kept interest rates unchanged at the June 25-26 meeting, it warned the lift from "inventory investment and the pickup in final demand appear to have moderated." Economists are betting on a turnaround in capital spending to give the recovery the extra oomph needed to carry it into 2003 and beyond. But less foreign investment coming into the U.S. and a bigger government role in the bond market means funds for new projects will not be as plentiful. Access to cheap credit fueled the New Economy boom. But thanks to twin deficits (charts), financing the economy may not be as easy in the future as it was in the 1990s.

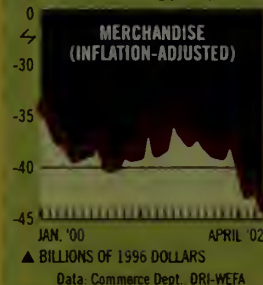
180-DEGREE TURN

in Washington's finances has been particularly stunning. The budget for fiscal 2002, which will end on Sept. 30, is on track to post its first deficit since 1997. Total spending from October to May is 10% from the same period the year before, while revenues have sunk by 11.7%. The Congressional Bud-

get Office projects a shortfall well above \$100 billion, and private forecasters put the total at more than \$150 billion in both 2002 and 2003, a sharp reversal from the \$127 billion surplus for 2001. Indeed, the \$277 billion swing would be the largest on record.

But while some of the rise in outlays and fall in revenues is due to the economy's cyclical slowdown, some is structural, created by permanent tax cuts and new defense and security priorities. According to the CBO, a rise in unemployment insurance is leading the spending jump. Once the economy is strong enough to generate a healthy pace of new jobs, these expenditures will shrink. But Washington will spend more on the war against terrorism, homeland security, and perhaps a military initiative against Iraq. As a result, Washington's outlays will continue to rise, but growth probably will slow back down to the 4% to 5% pace of the last few years.

THE TRADE GAP TAKES A TURN FOR THE WORSE



AT THE SAME TIME, the White House wants to make a permanent and significant cut to revenues. To be sure, in this fiscal year, much of the loss in tax revenues was the result of layoffs, pay cuts, fewer exercised stock options, and a fall in capital gains. But the CBO estimates that between "\$35 billion and \$40 billion of the \$161 billion decline in total receipts through May, 2002, resulted from changes in tax laws." The stimulus plan now before Congress will reduce tax rates for upper-income households even further. So even when the economy gathers momentum, Washington won't see a commensurate pickup in tax revenues.

The dangers to the economy from these fiscal woes are twofold. First, to fund outlays, Washington will have to draw more deeply on the credit markets. That means the U.S. Treasury will take funds away from corporate borrowers. This crowding-out could result in higher interest rates paid on all types of borrowing, from U.S. bonds to business loans to mortgages.

Second, Washington has lost its ability to respond rapidly to economic swings. A major reason for the mildness of last year's slump was the tax rebate quickly enacted by the White House and Congress. Those checks were possible because the government had piled

Business Outlook

up cash during four years of surpluses. Without that cushion, the government will not be able to react nimbly if the economy stumbles.

THE OTHER DEFICIT clouding the expansion's future is the trade gap—along with its much broader cousin, the current-account deficit, which also includes the balances for portfolio income and foreign transfers. The gaping current-account deficit reflects both the 1990s boom in investment and consumption and the foreign funds that helped to finance it.

Now, though, fewer foreign funds are available just when the U.S. needs them the most. U.S. external financing requirements ballooned in the first quarter, as the current-account deficit hit a record \$112.5 billion. The gap may swell further as the year progresses. The April trade gap increased to \$35.9 billion after averaging \$31.6 billion per month during the first quarter. A wider trade deficit will subtract a percentage point or more from second-quarter GDP growth.

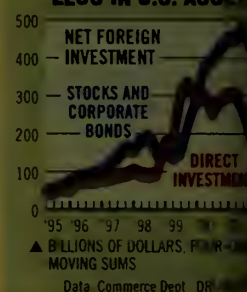
The longer-term problem is that less abundant foreign financing could limit the U.S. expansion. Foreign financing in the late 1990s allowed the U.S. to consume more than it produced, and it helped provide investment funds for tech startups and productivity-enhancing systems at nontech companies. From 1995 to early 2001, foreign net purchases of stocks and corporate bonds increased almost tenfold, and foreign direct investment rose sixfold.

But in the past year, foreign purchases of stocks and bonds are down 24%, and foreign direct investment is off 63% (chart). Geopolitical risks and mistrust in Corporate America take some blame for this red inflow. And a key victim is the dollar, down 12% vs. the euro and 10% vs. the yen since late February.

The dollar will decline further, but it should do so in a gradual and orderly fashion. Why? U.S. prospects for growth, productivity, and profits remain better than those in either Japan or Europe. Unit labor costs in Europe are rising, while in the U.S. they are falling. A lower dollar will make the country's producers more competitive, lift the earnings of its multinationals, and reduce dependence on foreign funds by narrowing trade gap.

The price of that narrowing, however, could be slower growth in U.S. investment and consumption, especially if Uncle Sam skims off more private savings, which could lift interest rates. The U.S. weathered the effects of the twin deficits in the mid-1980s, but given the new uncertainty of the stock market, battling them this time around could be tougher.

FOREIGNERS ARE INVESTING LESS IN U.S. ASSETS



GERMANY

WHAT'S PUTTING A DAMPER ON GROWTH

Recovery in Germany will remain halting through the year. The economy barely grew in the first quarter after two quarters of contraction, and while export-oriented businesses are making headway, domestic demand remains stymied. The economy will struggle to grow 1% this year.

Consumer spending and business investment both declined in the first quarter, and neither is gaining ground in the second. Retail sales in May fell for the second month in a row, as May unemployment posted the largest rise in five years. The jump resulted in part from new legislation, strike activity, and holidays, but it also reflected a large

number of job losers and poorer prospects of finding a job. Economic growth won't be strong enough to improve the labor market significantly until 2003.

Business sentiment is improving slowly. The closely watched index from the IFO institute dipped in June, and attitudes are mixed. Big exporters seem more confident, but builders and retailers are more pessimistic. On June 24, Germany's retail trade association slashed its sales forecast for this year.

Manufacturers' orders in April offered some hope as domestic orders gained. But April industrial production posted only a small rise. Output of export-sensitive

capital goods rose, but production of consumer goods fell. With a self-sustaining recovery nowhere in sight, companies are cutting their investment and hiring plans for this year, says a recent survey of 20,000 executives by the DIHK industry and trade association.

On the plus side, weak domestic demand and falling oil prices are moderating inflation and delaying the urgency for the European Central Bank to raise interest rates. The euro's 12% rise vs. the dollar since February is an additional inflation dampener.

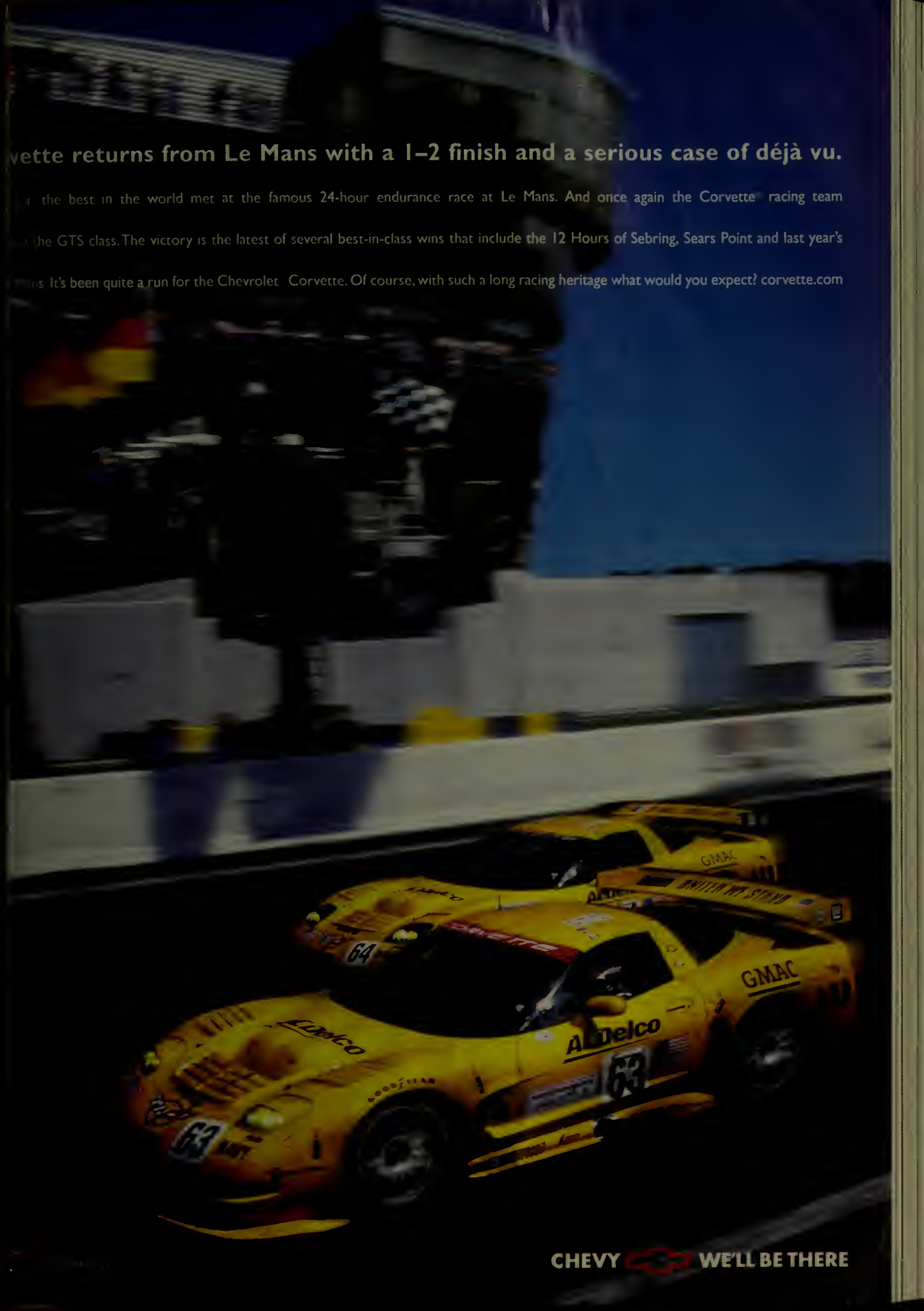
Eventually, rising exports will boost capital spending, and consumers will benefit from rising pay—helped by recent wage deals—along with low inflation and interest rates and planned tax cuts. But that is next year's story.

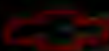
BUSINESSES CAST A WARY EYE ON THE FUTURE



Corvette returns from Le Mans with a 1-2 finish and a serious case of déjà vu.

At the best in the world met at the famous 24-hour endurance race at Le Mans. And once again the Corvette racing team won the GTS class. The victory is the latest of several best-in-class wins that include the 12 Hours of Sebring, Sears Point and last year's 24 Hours of Le Mans. It's been quite a run for the Chevrolet Corvette. Of course, with such a long racing heritage what would you expect? corvette.com



CHEVY  WE'LL BE THERE

CAN TRUST BE REBUILT?

*America is in shock, but
the corporate clean-up is
well under way*

BY BRUCE NUSSBAUM

Are we fools? Have we jeopardized our futures by buying into Corporate America's idea of a market-driven society only to be deceived by corrupt and unethical behavior on an unimaginable scale? As July 4 approaches, millions of Americans, already jittery about possible terrorist attacks, are now worrying about their financial security. With stocks sinking and the dollar swooning, they're wondering what they should do to protect themselves. They want to be safe. What they do in the months ahead will determine not only the course of the economy but also the political direction of the country.

Even President Bush, who has been reluctant to speak on the subject—and only then to blame individual “bad ap-

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The shockwaves spread



ples"—has broken his silence (page 35) on corporate corruption. "I am deeply concerned about some of the accounting practices that take place in America," he said at an international meeting in Canada. Bush called revelations about WorldCom's bookkeeping "outrageous" and vowed to "fully investigate and hold people accountable.... There is a need for a renewed corporate responsibility in America."

Well, yes. The simple truth is that people are walking around in a state of shock this summer. Talk to them on the beach or on the road, and they are anxious, angry, and not sure what to do. It has never occurred to them to question the basic truthfulness of companies or their corporate leaders. That trust is now coming undone. It was one thing to see the blowup in dot-coms as an anomaly. Even Enron Corp. could be perceived as a rogue. But the daily drip of scandal is spreading to all parts of the corporate scene. At Tyco International Ltd., there are major accounting problems and its CEO is charged with cheating on sales taxes—even tampering with evidence. There's Merrill Lynch & Co. paying \$100 million in fines for misleading investors. People scratch their heads at mainstream companies such as Stanley Works trying to evade taxes by setting up sham headquarters in Bermuda. (Ordinary taxpayers know they must make up the shortfall to pay for homeland defense and education.) They see trusted companies such as Merck & Co. booking questionable revenues. Finally there's Martha Stewart, the doyenne of domesticity, tarnished by allegations of insider trading and obstruction of justice. Martha Stewart!

The latest financial bomb—and potentially the most damaging to investor confidence—is WorldCom Inc. It may turn out to be the biggest fraud in American economic history—and the biggest bankruptcy. WorldCom appears to have sullied the one credible, true measure of company health left, cash flow, throwing doubts on practically all financial statements. Few companies ever used the esoteric stratagems that got Enron into trouble. But all corporations use cash flow and earnings before interest, taxes, depreciation, and amortization (EBITDA) as a measure of well-being. If WorldCom could fake nearly \$4 billion in operating cash flow (its auditor was none other than now-convicted Arthur Andersen LLC), then how can people be sure of any company? Where are the rest of the cockroaches?

So people everywhere are asking: Who and in what can you trust? Public confidence in Big Business is at its lowest since 1981, according to the latest Gallup Poll. Indeed, people are so alarmed they are poised to flee the markets entirely. The danger is that if investors and consumers run, they will take down the economy and the dollar with them. A growing buyers' strike in the stock market, the flight of money into housing, and the rising price of gold all indicate that the early stages of a panic may be building.

The timing couldn't be worse. The U.S. economy is showing signs of recovery. Momentum is building. Even corporate

A New Image Problem for Big Business

According to the latest Gallup Poll, the public has less confidence in Corporate America than in any year since 1981. Even television news and organized labor scored higher.

RESPONDENTS WITH A "GREAT DEAL" OR "QUITE A LOT" OF CONFIDENCE IN BIG BUSINESS

1999	30%
2000	29
2001	28
2002	20

*Surveys of roughly 1,000 people, each conducted in June

Data: CNN/USA Today/Gallup Poll

SPECIAL REPORT Scandals in Corporate America

profits seem to be making a decent comeback. But the cloud over the credibility of all financial numbers is undermining investors' confidence in proclaimed earnings. Are they real or fake? By the fall, the economic upturn could be in full swing. But if the corporate crime wave leads people to pull back from the stock market, the economy could sink into a double-dip recession.

What worries Americans most is that they might find themselves stuck in a long period of stagnation, like the U.S. in the 1970s or Japan in the '90s: Growth would slow, jobs would become scarce, unemployment would rise, stocks would stay flat, families would suffer deep stress. For baby boomers facing retirement, this is a frightening prospect. Most have bet just about everything on a rising stock market to finance their old age. With their 401(k)s flat for the past two years and going nowhere fast today, fiftysomethings are scared.

Perhaps too scared. The U.S. is not Japan. Pessimism is so rife now that people are blinded to how much economic reform is under way. Japan was paralyzed for nearly 10 years, unable to cope with its problems. In America, an enormous cleansing has already started.

Boards of directors are firing CEOs left and right. The turnover for chief executives has never been higher. The market is recalibrating, sending capital to companies with transparent, easy-to-understand financial statements while causing the rest to tank. Taking the hint, nearly 1,000 companies have restated their previous earnings, establishing more credible financial base lines. Pushing them along, the Justice Dept. has just given a death sentence to Arthur Andersen and is likely to teach Enron a severe lesson, sending a crystal-clear message about the consequences of corporate malfeasance.

More reform is on the way. On June 26, Securities & Exchange Commission Chairman Harvey L. Pitt, once the reluctant reformer, filed civil fraud charges against WorldCom. More important, he ordered the CEOs and CFOs of the 1,000 largest U.S. companies to attest personally to the accuracy of financial statements, starting with their most recent annual report. The New York Stock Exchange has also proposed new rules on corporate governance, requiring that a majority of corporate board members be independent and that shareholders get the right to vote on executive compensation (they are the owners, after all). The nonprofit Conference Board may soon propose an "oath" for CEOs to take, requiring

them to sign off on a range of issues, from truthful audit clean accounting for stock options. The Senate Banking committee just passed a tough accounting oversight bill goes a good deal of the way toward reforming the accounting profession—and widespread outrage over the WorldCom fraud makes it much more likely that strong legislation will emerge from Congress. Even a few CEOs, such as Richard Paulson of Goldman Sachs, are beginning to speak out.

Knowledgeable Corporate America's credibility problem and demanding reform.

But will it be enough? The Americans can appear to be longing for a new Age of Reform, such as the Teddy Roosevelt advanced at the turn of the century following a similar decline in public trust and confidence in the economic system. People want immediate action before it is too late. They are shocked by the contrast between the values exhibited by working-class firefighters, police, and soldiers on September 11 and those on parade taken over by much of the Corporate Elite. They feel that many of the most well-educated, and privileged managers and professionals in society have betrayed their fiduciary trust to the nation.

To most Americans, this goes beyond being an ethical issue. The high-growth '90s, which generated so many jobs, was based on financial innovation and deregulation. Millions accepted, for the first time in their lives, the conservative argument that they could control their own destinies and prosper by tying their lives to the market. They were convinced that they could manage the market through better information and thus garner more of the profits as well.

It worked. From 1995 to 2000, a New Economy delivered enormous prosperity to millions of people. Huge product gains were made, pushing up real wages and creating opportunities for mobility. Now, people are discovering that the bubble years, starting around 1999 or 2000, some began to fake this information and corrupt the market. Checks and balances failed, and professional accountants, lawyers, and analysts became greedy. The truth is that markets can work only if information is honest, rules of the game are clear, and people follow them. Realizing that isn't the case today has left many Americans doubting their own futures and jeopardizing the future of the economy.

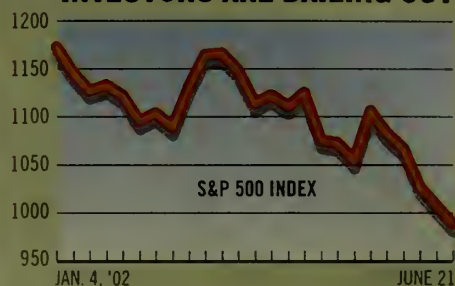
So are we fools? For the sake of the America's future, we had better not be.



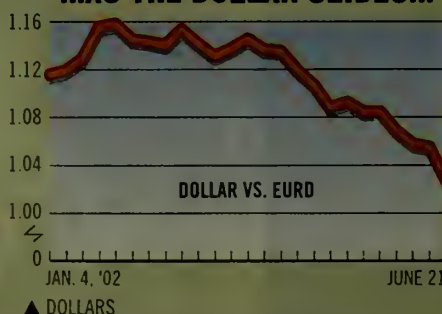
RUNNING SCARED Americans' financial anxiety is threatening an otherwise promising recovery

EROSION OF CONFIDENCE

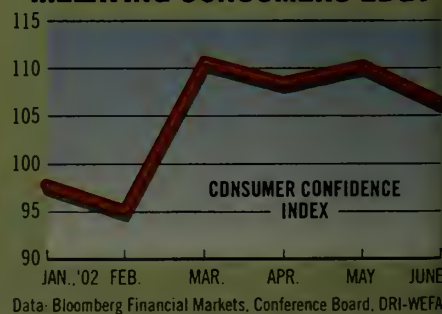
INVESTORS ARE BAILING OUT...



...AS THE DOLLAR SLIDES...



...LEAVING CONSUMERS EDGY



Data: Bloomberg Financial Markets, Conference Board, DRI-WEFA

COMMENTARY

By Lee Walczak and Richard S. Dunham

WILL THE CHIEF EXECUTIVE REALLY SPEAK OUT?

At a White House that's warily eyeing the widening ripples of the white-collar crime wave, a question has come to this: What should the President say, and should he say it? George W. Bush has hesitated for months as tales of accounting tricks, tax avoidance, and earnings manipulation spread through Corporate America. As investigations loomed, Bush's aides grew increasingly concerned that disillusioned investors might undermine the recovery, lose faith in Bush's probusiness economic policies, or—start taking revenge on Republican dates.

On the heels of WorldCom Inc.'s announcement of an inflated operating loss of \$3.8 billion, the sense that things are going unhinged in the business sector is rising. Bush clearly calls for leadership from the top. And he exemplifies what calls for the "Responsibility Era," Bush has been surprisingly reticent. On June 11, the President, at the global economic summit in Canada, gave his most detailed comments on the crime wave to date.

Bush called WorldCom's conduct "outrageous," and vowed hot pursuit of the wrongdoers. "We've had too many cases of people abusing their responsibilities," he said at a photo session with Britain's Tony Blair. "We will not let anyone within our laws those who are irresponsible." Despite the tortured phrasing, he made his point.

Still, it's an open question whether the flashes of Presidential frustration reassure the public that Washington is on top of the problem. Bush has been quiet since Mar. 7, when he rolled out a largely voluntary corporate-gov-



could spook investors, harm the expansion—and aid Democrats pressing for reforms

ernance plan that reformers contend falls well short of the sweeping changes that are needed. True, Bush is preoccupied with other weighty concerns, like the war on terrorism and the Middle East. But the fact is, he's deeply torn on the corporate crime issue because political advisers tell him it's a no-win situation for the GOP.

A Presidential critique that summons up images of systemic abuses, aides fear, could spook investors even more and harm the fragile expansion. It also would aid Hill Democrats who insist that permanent legislative reforms are needed—a stance conserva-

tives resist. More troublesome for the GOP, focusing attention on the scandals only serves to reinforce an emerging Democratic line of attack for the fall campaign: Republicans' deregulatory fervor and Bush's chumminess with powerful business interests created the conditions for the financial abuses that are now breaking into the open.

"Bush has to speak up," says one top GOP strategist. "Democrats are going to go on the offensive about Republicans' laissez-faire attitude toward business. But the President also needs to restore confidence in the system." Some Wall Streeters agree. "The President should use the bully pulpit more," says Mark P. Vitner, senior economist at Wachovia Corp. "If people don't have trust in Corporate America, they won't invest."

Bush, however, seems to prefer private arm-twisting. On June 20, he met with Business Roundtable reps and said CEOs must take strong steps to restore confidence in their financial reports. Bush's message, according to International Paper Co. CEO John T. Dillon: "I want you fellows to lead."

Going one-on-one with the corporate elite can be effective. But it's not enough, reformers say. "Bush may feel he can have more impact by directing his comments to movers and shakers," says DePaul University Professor Laura P. Hartman. "But these are the same people who are going to fund his reelection, so he seems conflicted—like an Arthur Andersen auditor."

As federal prosecutors zero in on

WHERE'S GEORGE? A critique of business

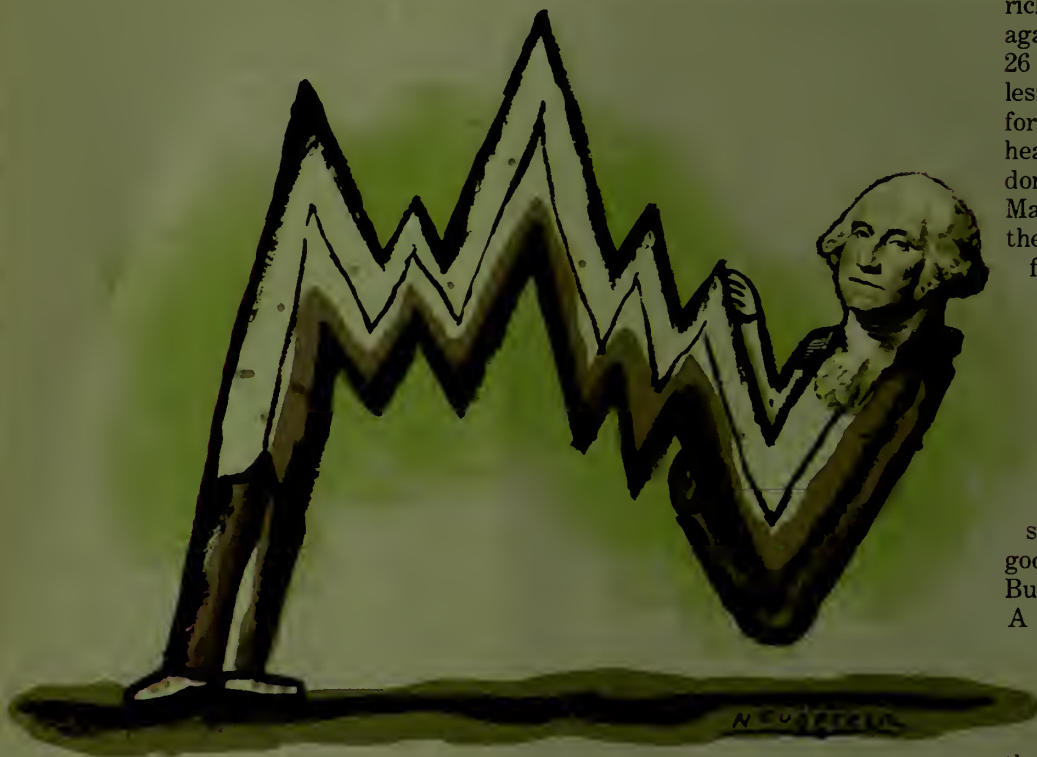
Enron Corp., the freewheeling energy-trading outfit intimately linked to both Bush and Veep Dick Cheney, chances are that the President will finally be compelled to speak out at length on the roots of the current mess and on his "let business clean up its own act" approach. Will his speech be driven by lofty moral imperative—or represent cold political calculation? The singed members of the Investor Class will have to judge for themselves.

Washington Bureau Chief Walczak and Senior Correspondent Dunham cover politics and policy.

COMMENTARY

By Peter Coy

THE DOLLAR IS FALLING— BUT THE SKY ISN'T



The U.S. dollar suddenly looks like a 98-pound weakling. The accounting scandal at WorldCom Inc. has added to foreign investors' fears that U.S. profit figures aren't to be trusted. On June 26, the dollar hit 98.3¢ per euro, the weakest level against that currency since February, 2000. The dollar bought only 120 yen, the fewest since last September. Since Apr. 1, when the dollar's slide began, it has lost more than 11% of its value against each major currency.

Some respected economists and market analysts worry that the dollar's slide could turn into a tailspin. Two of the preconditions for a dollar crash are in place: a giant trade deficit and a crisis of investor confidence. Such a downward spiral could mean big problems for the economy: Inflation would surge, export-led foreign economies would suffer, and there wouldn't be much the Federal Reserve could do. Any Fed attempt to stop a dollar crash by raising rates would kill the healthy housing market, stall the economy—and probably fail to bring back foreign investors anyway. "I'm con-

cerned," says Edward E. Leamer, an economist at the University of California at Los Angeles' Anderson School of Management. "The speed of the adjustment is the critical issue."

But things don't have to turn out for the worst. And most likely, they won't. The dollar loses altitude every few years, but it hardly ever takes a nose-dive. Because the dollar floats freely, there isn't the kind of pent-up selling pressure that afflicts currencies pegged to the dollar. Moreover, even if global investors are skeptical about the U.S., they have few better options: Europe is soft and Japan nearly comatose.

Indeed, despite the current market jitters, the dollar has some strong props under it. The productivity of the U.S. economy continues to improve, rising at a 4.3% annual rate in

the first quarter. Eventually, the economic recovery should revive profits and stocks. "A return to profits is imminent," predicts Carl B. Weinberg, chief economist of High Frequency Economics Ltd. in Valhalla, N.Y.

You wouldn't guess it from the headlines, but the dollar's decline to date has been modest. It has dropped a 8% since February against a basket of rich-country currencies. Measured against a trade-weighted index of 26 most important currencies, it's down less than 2% this year, after adjusting for inflation. Harriett M. Richmond, head of currency management for London-based J.P. Morgan Fleming A. Management, says that she believes the dollar's recent tumble has left it fairly valued, and that its long-term trend is up, not down: "The long-term relative-productivity trend for the dollar are still favorable," says Richmond.

Suppose the dollar does go down some more. What's the problem? As long as the decline is orderly and doesn't continue to spook foreign investors, it will be a good thing for the U.S. economy, says the Bush Administration quietly recognizing. A cheaper dollar would give a fighting chance to U.S. manufacturers and farmers who have been priced out of global markets. And it would push other nations to do what they should have done long ago: Lower interest rates and reform hidebound financial systems to stimulate domestic demand instead of counting on American consumers to keep their economies afloat. Sure, a weaker dollar will raise import prices in the U.S., but that's a small problem, with inflation so low.

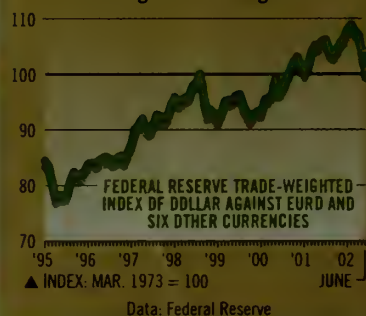
To close the trade gap, the dollar needs to keep falling. Exports are much lower than imports that they must climb 40% faster than imports just to keep the deficit from growing.

Economists at Goldman, Sachs & Co. predict that even if the dollar falls another 10%, the trade deficit will climb to record 5% of U.S. output by late 2002. Far from fretting about dollar weakness, people ought to worry that the dollar still isn't weak enough.

Coy is economist

A LIMITED DROP—SO FAR

While the dollar has weakened in recent weeks, it's still up from long-term averages





WHAT KIND OF DECISIONS DO YOU
MAKE IN HOLLYWOOD?
IF YOU'RE FOX, ENTERTAINING ONES.

need the right information
Fox Filmed Entertainment
this. That's how they've
one of the most
creators and distributors
films in the world.

And that's why they chose
Crystal Decisions™. Our web-
based reporting, analysis and
information delivery technology
helps Fox track critical business
information through distribution

channels and leverage that
information to make smarter
decisions. With over 10 million
licenses shipped, and partners
including SAP™ and Microsoft,
we've proven our solutions

deliver information, cut costs
and improve productivity.
Want to learn more? Visit: www.crystaldecisions.com/ent005/,
or call 1-866-821-3525



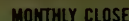
Its downfall may hurt rivals and kill telecom competition

And there may still be more skeletons in the closet: Sources close to WorldCom say internal auditors are uncovering further troubles. Those include double-counting of revenue as far back as 1999, debt that may not have been



That may depend on S more remaining above fray. Both he and Ebb along with Sullivan and o execs, are being investig by the SEC. If it turns that Sidgmore, who vice-chairman during 2 knew what was going on, or that rubber-stamped Sullivan's account he too could be forced out. Sidgm declined comment, but released a st

APR. 30, 2002 Ebbers resigns as WorldCom CEO after SEC launches inquiry into the company's accounting practices and loans to Ebbers. Vice-Chairman John Sigmund takes over as CEO.



saying, "I have committed to driving a fundamental change at WorldCom, this matter will not deter the management team." Neither Ebbers nor [unclear] could be reached for comment. In the near term, WorldCom's woes spell opportunity for the rest of the industry, as rivals like AT&T and [unclear] Corp. scramble to steal WorldCom customers. "The message we're getting from management is 'We've got WorldCom on the mat. It's time to kick it,'" boasts one sales rep at AT&T, who reacted with offers of broad discounts to such WorldCom customers as Reynolds Tobacco.

In the long term, the WorldCom scandal may force a fundamental restructuring of the telecom industry. Ebbers was more than just another telecom executive. He came to represent the competitive industry that grew up in the 1980s and 1990s to challenge the old Ma Bell monopoly. Now WorldCom's collapse could spell trouble for those few remaining upstarts. Analysts fear that financing could dry up, lenders may begin calling in loans to phone companies, and assets could plunge as WorldCom joins the long list of companies dumping securities. Scott Cleland, president of Precursor Group, says that 24 of 29 telecom firms he tracks are already technically at risk of bankruptcy. WorldCom's woes are "creating a vacuum that pulls others into the same."

What could spell the death of telecom competition. The regional Bell opera-

tors may be the only large players to emerge from the current fiasco in solid financial shape. As newcomers collapse for lack of funding, and WorldCom is forced into a fire sale to raise cash, the Bells may be able to buy some of WorldCom's plum assets for pennies on the dollar. Some analysts expect them to acquire AT&T and Sprint eventually, too. If that occurs, the Bells will end up with nearly complete control of many communications services.

And WorldCom's troubles will ripple far beyond telecoms. Banks and hedge funds have scooped up its bonds, betting that its business is healthy enough to give them a solid return even if its stock continues to fall. But the accounting scandal hammered WorldCom bondholders. On June 26, its bonds plummeted 73%, to trade between 12¢ and 15¢ on the dollar. "Telecom bonds have been in trouble for some time, and it looks like they will continue to be," says

On June 25, 2002 CFO Scott Sullivan fired as WorldCom announces \$3.8 billion accounting error. WorldCom halts trading in WorldCom stock.

MISSISSIPPI BASE



Data: Bloomberg Financial Markets

**FORMER
CEO EBBERS**



LOST CAUSE? *Sidgmore still hopes to lead the company in a turnaround*

Gina Haas, a spokesperson for High Yield Advantage Data.

It wasn't supposed to end this way for WorldCom. Despite Ebbers' image as a wheeler-dealer, analysts had always viewed WorldCom as a cut above go-go rivals such as Qwest International and Global Crossing Holdings Ltd. Their business models required investors to bet that the huge upfront outlays required to gain scale would eventually lead to big profits. WorldCom, by contrast, already possessed a stable of real assets such as MCI as well as blue-chip customers such as Nasdaq and AOL Time Warner Inc. When its market capitalization peaked at \$115 billion in 1999, WorldCom was the fifth most widely held stock in the country.

Now, the allegations of fraud are calling into question WorldCom's earlier performance. Simon Flannery, a telecom analyst at Morgan Stanley, estimates that as a result of the restatement, WorldCom's operating margin is just 16.8%—a fraction of the 30%-plus margins it boasted as recently as 2000 and the 21% that it still claimed prior to the disclosure. Investors now wonder whether WorldCom's outsized profits in the 1990s were nothing more than accounting fiction. WorldCom "was a momentum-growth scam," says Cleland.

At the center of the storm is Sullivan. A graduate of the State University of New York at Oswego, he signed on to KPMG's Albany office in 1983, where he saw the mergers and acquisitions game firsthand while helping to audit the General Electric Co. account. Sullivan showed up on Ebbers' radar in 1992, when WorldCom acquired Advanced Telecommunications Corp., a small long-distance provider in Atlanta

where Sullivan was then serving as CFO. Ebbers quickly promoted Sullivan through the ranks, and named him WorldCom's CFO in 1994. But as popular as he was with Ebbers, Sullivan quickly rankled division managers by sending junior accountants to double-check their books—which the managers viewed as unnecessary and demeaning. Over time, some division managers began to suspect that Sullivan—with Ebbers' support—was increasingly pushing the envelope with his hyper-aggressive accounting. "We'd send in one set of numbers and then see different numbers in the final financial reports," sighs one executive in WorldCom's MCI division who recently left. "No one would listen to us when we complained."

Now it appears that Sullivan's accounting may prove to be the last straw for WorldCom. After Sidgmore took the helm in April, he ordered a

sweeping assessment of WorldCom's businesses—including a thorough re-amination of the company's books. It was part of a 30-day review that he hoped would rebuild momentum at WorldCom. But questions were already starting to build. According to WorldCom insiders, the company's lenders began to conclude its financial picture was worse than imagined. As they reviewed the books in preparation for tough negotiations over new financing, bankers began to find that some of WorldCom's myriad divisions and subsidiaries were holding debt that had never been consolidated on the company's balance sheet. When they confronted Sullivan about it, they were troubled by his answers—and negotiations stalled sharply. "The banks began to see WorldCom as shady," says an executive who has talked with members of WorldCom's internal auditing team.

The real shocker came in early May. One of Sidgmore's auditors found that WorldCom had booked some ordinary expenses as capital investments, a move that enabled it to spread outlays over many years, and made it appear profitable in 2000. In the first quarter of 2002 when it was clear WorldCom pointed out the discrepancies to investigators from the SEC, the company was in the midst of their own problems with WorldCom's accounting. As a result, on June 25, WorldCom dropped a bombshell—along with news that it had fired Sullivan, and that the company's controller, David Myers, has resigned. And with that, WorldCom's mighty empire may be remembered as a mirage.

By Charles Haddad and Dean I. ... in Atlanta and Steve Rosenbush in New York, with bureau reports

What Comes Next?

Here's how the WorldCom drama is likely to unfold in coming months:

TALKS WITH LENDERS Because of its financial restatements, WorldCom has violated the terms of its \$8 billion in loans and lines of credit. It's trying to negotiate fresh credit with Citi, J.P. Morgan Chase, and other banks.

BANKRUPTCY PLANNING If WorldCom can't cut a new deal with its banks, it will likely seek bankruptcy protection.

SALE OF ASSETS WorldCom is also rushing to raise cash by selling off assets such as its international operations and its MCI long-distance unit.

WOOLING CUSTOMERS WorldCom is struggling to maintain its quality of service in order to hold on to blue-chip clients such as FedEx and Provident.

PREPARING FOR SALE If all else fails, WorldCom may be acquired by Verizon, SBC, or another phone company. It must put its house in order so it can command the highest price.

HOW TO HIDE \$3.8 BILLION IN EXPENSES

When WorldCom Inc. revealed on June 25 that it had uncovered a \$3.8 billion accounting fraud, one from the smallest investors to President George W. Bush reacted with anger and outrage. How was this possible? How could such an established company have hidden such huge expenses from the investing public? Here's a look at what WorldCom did and how the company did it.

What exactly did WorldCom do? During 2001 and the first quarter of 2002, the company counted as capital expenditures \$3.8 billion that it spent on everyday expenses. This makes a difference because capital investments are recorded differently from other expenses for accounting purposes. Capitalizing is money used to buy long-term assets, like fiber-optic cables or switches that direct telephone calls, so the cost is spread out over several years. For example, if WorldCom spent \$10 million on switches expected to last 10 years, it would book a \$1 million expense for each year. In contrast, if it spent \$10 million on office space, it has to expense all of that expense in the period in which it occurred. The company says that expenses that are counted as capital expenditures include "line costs," which are fees WorldCom pays to other telecom players for the right to access their networks.

Does this affect profits? Counting everyday expenses as capital investments boosts net income because expenses that are supposed to be spread out in one quarter are spread out over several years. WorldCom originally reported net income of \$1.4 billion in 2001 and \$1.1 billion in the first quarter of 2002. Now the company says it lost money the whole time. "You do this to make the bottom line look better," says Marie Kalinowski, an analyst with rating agency Standard & Poor's.

How is cash flow affected?

Different people use the term "cash flow" to mean different things. What WorldCom did affects cash generated from operations, a closely watched line in financial statements. WorldCom originally reported that its operating activities in 2001 produced \$7.7 billion in cash. Now, it says that figure really was \$4.6 billion. But WorldCom's overall cash flow isn't affected because the restatement will lower the amount of cash reported as used in investing activities, which include capital invest-

Net cash provided by operating activities	5,330	2,336	—	7,666
---	-------	-------	---	-------

Net cash used in investing activities	(13,612)	(773)	—	(14,385)
---------------------------------------	----------	-------	---	----------

Net decrease in cash and cash equivalents	(86)	(29)	—	(115)
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PRESTO! By shifting billions in expenses from operations to investing, WorldCom made its business look much healthier

ments. So the two changes cancel each other out. It does, however, affect another measure of cash flow, something called EBITDA.

What's EBITDA?

EBITDA stands for earnings before interest, taxes, depreciation, and amortization. Investors see this as a more accurate barometer of a company's health than cash flow from operations. This is where WorldCom's accounting games had the biggest impact. The company originally reported that its EBITDA for 2001 was \$10.5 billion; now it says the figure really was \$6.3 billion. In the first quarter, it reported EBITDA of \$2.1 billion, while the real figure was \$1.4 billion. In other words, WorldCom was in much worse shape than investors and banks

thought. "This is an industry where companies trade based on EBITDA," says Robert Willens, an accounting expert at Lehman Brothers Inc. "Capitalizing expenses has a direct impact on EBITDA."

Does this mean investors can no longer rely on cash flow?

Not necessarily. Capitalizing expenses is not that common because it's so easy to detect. While there are some gray areas, it's pretty clear what should be counted as everyday expenses

and what should be counted as capital expenditures. "This is sort of obvious to anyone who bothers to look at it," says Willens. "This doesn't involve offshore partnerships or special purpose entities. This is Accounting 101."

So where were the auditors?

Good question. WorldCom's auditors were from Arthur Andersen LLP, which says its work for the company complied with all accounting standards. The WorldCom fraud came to light when John W. Sidmore became chief executive in April and ordered an internal review of the company's books. The probe was conducted by WorldCom's new auditor, KPMG, as well as WorldCom employees. At its completion, WorldCom announced the restatement and fired its chief financial officer, Scott D. Sullivan. If there is a problem lining in the WorldCom fraud, it's that this sort of accounting fraud can be uncovered quite easily—yet it's not accountants who are looking for it.

By Peter Elston, New York

SURPRISE! THE LITTLE GUY LOSES

Big banks offloaded their risk
—mostly to small investors

Stocks of financial behemoths Citigroup, J.P. Morgan Chase, and Bank of America plunged on June 26 on fears that they'd be dragged down by huge losses from WorldCom Inc.'s collapse. They and other banks underwrote \$29 billion in bonds and arranged \$8 billion of credit lines for it. But most of the pain from the telecom giant's implosion will be felt on Main Street, not Wall Street.

The banks have become masters at offloading the financial risks of their lending by repackaging and selling it to pension and mutual funds, insurance companies, and even ordinary investors. That ability was a big plus during the roaring '90s because it enabled them to bankroll the New Economy. The outstanding debt of nonfinancial companies more than doubled, to \$4.9 trillion in the first quarter of 2002 vs. \$2.4 trillion during the same quarter of 1990, according to the Federal Reserve. Trouble is, easy credit hatched highly leveraged upstarts such as WorldCom that are now floundering under their huge debt loads.

Here are the likely losers if WorldCom goes bankrupt:

Pensions and 401(k) plans: Citigroup underwrote WorldCom's last bond deal, an \$11 billion issue in spring 2001. But the biggest holders of WorldCom's \$29 billion in bonds include Prudential Securities, California Public Employees' Retirement System, and MetLife, according to bond researcher Capital Access International. Together, the three hold \$1.25 billion worth of the bonds, which traded at 13¢ on the dollar on June 26, down from 65¢ the day before. Also, since the start of the year, WorldCom stock has lost more than \$40.4 billion in value. The biggest holders are all leading asset managers that run pension and mutual funds: Alliance Capital Management, Wellington Management, and Barclays Bank.



MORE TO COME? While banks such as Citigroup say they will avoid big loan losses, their analysts including Grubman (left) of Citi's Salomon Smith Barney, face scrutiny by the New York Attorney General for their WorldCom ratings.

Bank-loan funds: Big banks have lent

WorldCom \$2.65 billion in unsecured loans. Typically, they keep under 10% of loans they arrange, syndicating the rest to smaller banks, insurers, and loan funds sold to individual investors. Asset managers, such as Eaton Vance, Van Kampen, and Fidelity Investments, had \$22 billion in bank-loan funds at the end of May, according to Lipper Inc. Owners of such funds tend to be "individual investors who thought they were savvy and turned out not to be" because the investments are turning out to be high risk, says Donald Cassidy, a senior research analyst at Lipper.

Consumer spending: Analysts say that because banks have offloaded so much risk, a WorldCom bankruptcy could put a severe squeeze on consumer spending, one of the economy's stronger spots.

"People are feeling poorer, and they have a statement to prove it at the end of the quarter," says Cassidy.

Research analysts: New York State Attorney General Eliot Spitzer said June 26 that he will investigate Wall Street research on WorldCom. His line is controversial telecom analyst Grubman of Citigroup's Salomon Smith Barney, who issued a downgrade on stock the day before WorldCom's shell. A spokeswoman for Grubman said he was "just as stunned as everyone else" by the announcement.

Oddly enough, even though banks may have dodged the WorldCom bullet for now, they're the ones holding the gun to the company's head. Because WorldCom is in default on \$2.65 billion in bank loans, bankers can force it into bankruptcy. The company's lenders could then liquidate WorldCom's assets and pay them back before anyone else. A few are hesitant. "I think it's sensible for them to push this company into Chapter 11," says one lender. But others are gunning-ho to do just that. Says one, "They're not getting any more money from us unless they file for bankruptcy."

By Heather Tim
in New

Holding the Bag

Owners of WorldCom's
stocks, bonds, and loans—
mostly pension and mutual
funds—face big losses

- ▶ **Stock value** destroyed since Jan. 1: \$40.4 billion
- ▶ **Bond value** destroyed since issue: about \$25 billion
- ▶ **Unsecured bank loans** drawn down: \$2.65 billion out of an \$8 billion credit line

Data: Capital Access, Morgan Stanley, Bloomberg Financial Markets

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ADELPHIA'S FALL WILL BRUISE A CROWD

The bankruptcy is hurting rivals as well as suppliers

Two years ago, Scientific-Atlanta Inc. was so eager to sell set-top boxes to Adelphia Communications Corp. that it offered to advance the cable-TV operator \$26 a box to help market a new digital service. These days, the deal doesn't look quite so enticing. On June 10, scandal-ridden Adelphia acknowledged that it never spent the marketing money—using it instead to reduce reported expenses. And today, with Adelphia in Chapter 11 reorganization, Scientific-Atlanta will have a tough time collecting the \$83.8 million Adelphia owes it.

Scientific-Atlanta may want to take a number. For weeks, as the nation's sixth-largest cable company has careened from one accounting revelation to another, suppliers of programming and technology have been bracing for likely losses from Adelphia contracts. Indeed, they're gearing up to ask the courts to put them at the front of the line by declaring them "critical vendors," meaning Adelphia couldn't stay in business without them.

Walt Disney Co., which sells Adelphia its ESPN sports programming, will see its cash flow cut by \$50 million as a result of the bankruptcy, figures Merrill Lynch & Co. News Corp. officials acknowledge they are owed as much as \$20 million for Fox News, FX, and other channels. And pay-per-view vendor In Demand thought it had figured out a way to not get burned: It required Adelphia to put up \$1.2 million for the Mike Tyson-Lennox Lewis fight on June 8. But In Demand is still owed money for Major League Baseball games.

It's not just suppliers that will feel the ripples of Adelphia's bankruptcy. Rival cable operators have been under pressure since Adelphia said

it hadn't disclosed some \$3 billion in off-balance-sheet loans to the company's founders, members of the Rigas family. Although no other cable companies have been accused of similar shenanigans, Adelphia's meltdown—and now WorldCom's problems—has left investors wary of debt. On June 26,



The Adelphia Effect

The list of creditors is growing, and there may be more surprises as probes continue

CONTENT

► Companies that provide shows to Adelphia—from CNN and Fox Sports to MTV—will be stiffed on bills for their programming. ESPN-owner Disney is expected to take a \$50 million hit.

EQUIPMENT

► Technology vendors may not get paid for services and gear. Set-top-box maker Scientific Atlanta, for instance, is owed \$83.8 million.

COMPETITORS

► In the wake of Adelphia's woes, cable stocks have tumbled, with highly leveraged companies such as Charter Communications and Cablevision down by roughly 70%.

shares of heavily indebted cable operators Charter Communications Inc. Cablevision Systems Corp. fell by 26%, respectively. Since Adelphia's woes were revealed in March, both off by some 70%.

Moreover, Comcast Corp.'s stock fell 9% in mid-June in the wake of Street rumors that rating agency Moody's Investors Service would downgrade the cable operator's debt after it completes its \$35 billion merger with AT&T's cable unit. N. Begley, a senior vice-president at rating agency Moody's Investors Service, counts the rumors but says he understands the hair-trigger nerves of investors. "The concern is that there are a lot of founding families still running cable companies," he says.

Still, with Adelphia's problems aging their shares, cable companies have trouble completing deals. Charter, which is looking to expand through acquisitions, likely need more cash from majority owner Paul Allen than so. Cox Communications considered one of the industry's best operators, has its stock fall by 28% in March even though it expects to reduce capital expenditures and increase cash flow this year. "We're not sure what we can try next," laments CEO James O. Robbins.

Despite the troubles, many and technology companies covet Adelphia's 5.7 million subscribers in Los Angeles, southern Florida, and elsewhere. Anticipating that Adelphia will sell some of its choice systems to get money from the court to keep operating, Disney and others have signed deals to secure space on digital systems Adelphia is planning. Why deal with a sinking company? "If they're long-term contracts with time to run on them, bankruptcy court could be in effect when those terms are sold off or restructured," says Richard B. Leary, a partner at Skadden, Arps, Slate, Meagher & Flom LLP.

That could be wishful thinking. And there could be more surprises as independent board members investigate the Rigas family deals. Even now, however, the line at the bankruptcy court looks plenty long.

*By Ronald Grove
Los Angeles*

ED BY MONICA ROMAN

NG GENENTECH THER LITTLE JAB

NTECH WILL TAKE A \$500
n charge against second-
er earnings to cover
ges that a Los Angeles
ordered the biotech gi-
o pay the City of Hope
r hospital. On June 24,
ry added \$200 million in
ive damages to the
2 million in compensatory
ges it had already levied
st Genentech, after de-
g that the company
l City of Hope out of li-
ng revenue from a tech-
y developed by the can-
enter. The penalty won't
the bank for Genentech,
has \$1 billion in cash.
ntech will appeal the ver-
a process that will prob-
take more than a year.

EX DELIVERS IE GRIM NEWS

EDEX FORESHADOWING
nged pain for the U.S.

LOSING BELL

NO RESPECT

n before the WorldCom
idal, AOL Time Warner's
k was a laggard. On June
it sank 11.49%, to
.63, because, like World-
n, it uses earnings before
rest, taxes, depreciation,
amortization (EBITDA) as
preferred financial meas-
ure. Can it be long before
lia moguls ditch EBITDA?



STOCK PRICE

NE 18, '02 JUNE 26
Data: Bloomberg Financial Markets

economy? Despite doubled
profits in the fiscal fourth
quarter, the shipping giant
saw its stock price plunge
14%, to \$48, on June 25.
FedEx investors are con-
cerned about the possibility
of weak profits for the first
quarter ending Aug. 31, and
for the full year. The Mem-
phis company said that it
didn't expect an economic re-
covery until early next year.
The reason: Its customers in
the manufacturing, high-tech,
and wholesale sectors have
yet to ramp up delivery
spending. Manufacturers rep-
resent 40% of FedEx' do-
mestic express-delivery busi-
ness. Meanwhile, FedEx'
lower-cost ground-delivery
operations saw volume in-
crease 21% in the fourth
quarter, a sign that its cus-
tomers are remaining cost-
conscious.

A FLOTATION DEVICE FOR UNITED?

UAL IS TESTING JUST HOW FAR
the government will go to bail
out the airline industry. The
parent of United Airlines, the
world's No.2 carrier, asked
the Air Transportation Stabi-
lization Board on June 24 to
guarantee \$1.8 billion in loans.
UAL ended the first quarter
with \$2.9 billion in cash, and it
won pay cuts from its 11,000
salaried workers and 9,200 pi-
lots totaling \$950 million over
three years. But the airline
says it needs new loans so it
can pay off \$1 billion in debt
due by early 2003, spend \$500
million for spare parts and
other capital gear, and cover
losses of \$5 million a day. So
far, the board has backed
loans for only one major car-
rier, America West Airlines.

BATTLING OVER TRW'S DEFENSE BIZ

NORTHROP GRUMMAN'S PLAN
to acquire all of TRW for \$7
billion was dealt a blow when

HEADLINER: MARTHA STEWART

ALL THIS FOR CHUMP CHANGE?

COULD THINGS GET MUCH
messier for Martha Stew-
art? In addition to ward-
ing off suspicions of in-
sider trading of
ImClone Systems
stock, America's
homemaking
queen now faces
the specter of
obstruction of
justice charges
from federal
prosecutors.

The latest wrinkle:
a Merrill Lynch sales as-
sistant who disputes the
reasons both Stewart and
her broker give for selling
the stock a day before bad
news sent it reeling. That
sale brought her less than
\$230,000. In return, the do-
mestic diva has lost hun-
dreds of millions on paper

as the scandal has almost
halved the value of Martha
Stewart Living Omnimedia
shares in recent weeks,
to \$10.40 on June 26.



The big question
is whether the
whiff of impropri-
ety might now
turn consumers
away from the
bedsheets and
books that bear
her name. Stewart
has dismissed the
various allegations as
ridiculous and continues to
ply the cocktail circuit and
toss salads on TV as if noth-
ing were wrong. But in-
vestors are clearly worried
that America's arbiter of
good things could become a
symbol of bad behavior.

Diane Brady

three other bidders emerged
for the company's prized de-
fense-electronics and space
businesses. TRW may seek
higher offers from the inter-
ested parties, which now in-
clude General Dynamics,
Raytheon, and BAE Systems.
TRW announced plans on June
18 to sell its aeronautical-sys-
tems unit to Goodrich for \$1.5
billion. The company is con-
sidering a sale or spin-off of
its third major business, auto
parts. Northrop and partner
Lockheed Martin meanwhile
won an \$11 billion contract
to develop a new line of
stealth ships and aircraft for
the U.S. Coast Guard.

QUEASINESS AT IMMUNOGEN

IMMUNOGEN GOT A DOUBLE
dose of bad news on June 24
about its experimental cancer
drugs. First, development
partner GlaxoSmithKline an-
nounced it would conduct no

further clinical trials of Cam-
bridge (Mass.)-based Immuno-
Gen's cantuzumab mertansine,
an antibody that delivers
chemotherapy directly to the
heart of cancer cells. The
reason wasn't given, and Im-
munoGen says it will try to
renegotiate its pact with
Glaxo. Hours later, Genentech
said it would delay human
testing of a similar drug li-
censed from ImmunoGen until
it had conducted more animal
and lab tests. The dual an-
nouncements caused Immuno-
Gen's stock to drop 46% on
June 24, to \$2.15 a share.

ET CETERA...

- Supervalu will take a charge
of up to \$21 million to account
for inventory misstatements.
- Priceline.com said it ex-
pected second-quarter earn-
ings of 3¢ a share.
- CMS Energy has hired a
law firm to review its energy-
trading operations.



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INFORMATION COMING INTO YOUR BUSINESS THAN EVER BEFORE.

BUT THEN, THAT'S ALSO THE BAD NEWS.



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ED BY PAULA DWYER

SOFT MONEY: IS IT THE END—OR THE END RUN?

Campaign-finance reform has always been a Sisyphean task. For years, special interests, adverse court rulings, and a divided Federal Election Commission have thwarted efforts to stop the flood of money pouring into the political m. Now, all three are conspiring to frustrate the intent of a sweeping reform measure pushed through by Senators McCain (R-Ariz.) and Russell D. Feingold (D-Wis.) and signed into law by President George W. Bush just a few days ago.

Essentially the most damaging turn of events: attempts to create surrogate parties would step into the void on Nov. 6, when national parties are banned from raising money—unlimited donations to political parties by corporations, labor unions, and the like. Even though they may be thinly disguised proxies run by ex-party officials, the law says it will treat them as independent and not constrained by the soft-money ban. A license for federal parties to evade the law, says Fred Wertheimer, president of pro-federalism group Democracy 21.

The FEC's new rules make it easier for parties to remain involved in raising large contributions in other ways, too. The agency will allow speakers to speak at state party functions if the soft money checks are collected. It's definitely soft-money solicitation as an overt request for dollars—thus making legal a "suggestion" that a donor give a \$100,000 check. But the pièce de résistance was a 22-2 vote to let the two political parties spin off committees no more than front groups to handle soft money. Then before the FEC vote, special interests were jostling to become the parties-in-mufti and take control of the money purses, which came to \$500 million in 2000. Since then, Michael Lux, a former Clinton-Gore fund-raiser, has been meeting with some 150 liberal groups, including EMILY's

List, the NAACP, and People for the American Way. This so-called Progressive Donor Network hopes to position itself as a one-stop account for liberal givers who once wrote large checks to the Democratic National Committee (DNC). A rival group, the centrist New Democrat Network, hopes to draw corporate donors who once contributed to the DNC.

Superlobbyist Ed Gillespie is leading a similar Republican effort. Like the Dems, Gillespie hopes to concentrate money and spend it where it is needed most rather than dilute it

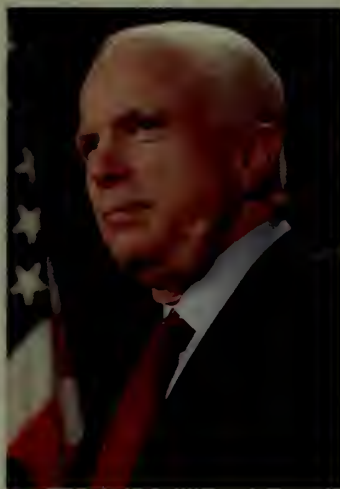
among dozens of uncoordinated groups. "It is not in the interest of Republicans to let a thousand flowers bloom," he says. His goal: to raise \$15 million to \$25 million every election cycle.

Naturally, this has McCain & Co. hopping mad. On June 26, McCain said he will push legislation to overturn the FEC rules. Even DNC Chairman Terry McAuliffe is uneasy. The fundraising maestro, unwilling to watch the soft-money spigot dry up, is touring the country to teach donors how to comply with the new law while maximizing their giving. McAuliffe's strategy: ask \$100,000 donors to give \$25,000—the new legal limit—and persuade the donor's spouse and adult children each to give \$25,000 of their own. "I'm not trying to get people to go to auxiliary groups," McAuliffe says. Still, the DNC and the Republican National Committee are cutting legal ties to state party chairmen,

freeing them to act as national party fronts by placing them beyond the law's reach.

With just four months to go before campaign reform takes effect and with the Supreme Court set to hear a constitutional challenge in December, the post-Nov. 6 landscape remains blurry. But the purse is power, and despite the soft-money ban, party leaders and their allies have no intention of surrendering control.

By Lorraine Woellert



McCain: Hopping mad

CAPITAL WRAPUP

SEASON ON LIEUTENANTS

With state budgets in crisis and government services being slashed, it's a terrible year to be an incumbent governor running for reelection. It's even worse to be a lieutenant governor seeking a promotion. On June 25, Bob Peeler of South Carolina became the fourth lieutenant governor elected in 1998 to be defeated in a Republican gubernatorial primary this year. Peeler followed flops in Missouri, Idaho, and Alabama. And acting Massachusetts Governor Jane

Swift, who took the top spot when Paul Cellucci became Ambassador to Canada, retired rather than face an uphill GOP primary slog against Salt Lake Olympics savior Mitt Romney.

Other current and former lieutenant governors face tough general-election fights. Among them: Wisconsin's acting governor, Scott McCallum, and Michigan Lieutenant Governor Dick Posthumus, who will be an underdog in November if he survives a primary fight.

What's going on here? Second bananas often are blamed when things go wrong in the boss's administration,

and they rarely get much credit when things go right. With voters tired of state budget woes, "They're all in trouble," says Bernadette Budde, senior vice-president for the Business-Industry Political Action Committee. "Lieutenant governors are the [political] equivalent of dog meat."

Only two ex-lieutenants are favored for promotions: Rick Perry, who succeeded George W. in Texas, and Maryland's Kathleen Kennedy Townsend, whose name helps. But there's still plenty of time for disaster to strike.

By Richard S. Dunham

FRANCE

FRANCE INC. FOLLIES

Two of its high-profile companies find themselves in deep trouble

There is something just so French about the spectacular rise and the messy fall from grace of France Télécom chairman Michel Bon and Vivendi Universal CEO Jean-Marie Messier. Their ascendance demonstrated what could result when audacity was backed by the collective firepower of the French state and French finance. And their humbling is a reminder of the increasing limitations of France Inc.

Under French law, the government must maintain majority control of France Télécom's capital. That means Bon has had to pay cash rather than shares for acquisitions—building up one of the largest piles of corporate debt in the world. Messier, meanwhile, deftly used the clubby relationships at the heart of France Inc. to build his media empire. Now, the club has begun to turn against him, with close ally Bernard Arnault, boss of LVMH Moët Hennessy Louis Vuitton, quitting the board on June 25.

Both men are blaming "speculators," "hedge funds," and "arbs" for plunging share prices. Yet market rules are the ones that count. Had Messier been more straightforward with his board, and had Paris loosened its grip on France Télécom, the two CEOs would be on a more solid footing. The question is whether France Inc. is learning the lesson.

Save for a nasty cold, Michel Bon doesn't look like a man under stress. Dressed nattily in a gray suit, the chairman of France Télécom gamely showed up for a mid-morning press show-and-tell on June 25 at the company's research center just south of Paris. But the crush of reporters and TV camera crews that greeted Bon wasn't interested in seeing him demonstrate a new wall-size videoconferencing system. All they wanted to know was how France Télécom's boss is going to solve a spiraling crisis at the company.

While U.S. investors panic over the American telecom sector, France Télécom has its own \$60 billion dollar question to answer. That's how much

debt the telco is carrying—the legacy of a spending spree that turned the French company into the most debt-ridden carrier on earth. Until recently, investors warily accepted that the phone giant could afford to spend \$4 billion a year on interest out of its \$12 billion in operating income. Then, in mid-June, came news of yet another liability:

France Télécom's ma

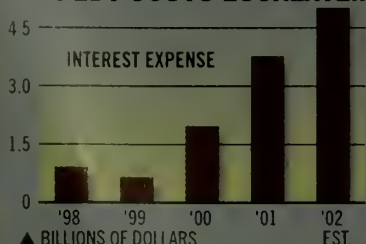
France Télécom may have to sh... an additional \$4 billion to protect... vestment in German telco Mobil...

Shareholders pressed the sell b... Their fears turned to panic foll... the June 24 decision by Moody... vestors Service to downgrade F... Télécom's debt to one notch above... level, citing concerns it may not b... to find buyers willing to refinance... ly \$15 billion in bonds that come o... the first half of next year. Stand... Poor's followed suit on June 25. F... Télécom says the moves will add... million to its annual debt-servicing...

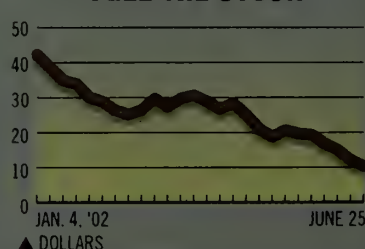
Market reaction has been b... Since June 19, France Télécom's s... have tumbled 40%, and are now tr...

at only one-third the... at which they were... offered to the public... years ago in Fra... largest privatization... the first time, ana... are suggesting th... massive government... out or sales of core a... may be required to... vage this Gallic... France Télécom's m... capitalization has su... just \$10 billion—\$7.5

AS FRANCE TELECOM'S DEBT COSTS ESCALATE...



...JITTERY INVESTORS FLEE THE STOCK



Data: Bloomberg Financial Markets, Commerzbank Securities

ENTRENCHED

Bon's tenure is political, so he's unlikely to lose his job, at least for now

lion less than the 84% stake it owns in European wireless operator Orange. Thus, the markets ascribe negative value to the company's \$42 billion in annual revenues, 90 million customers, and \$31 billion in physical assets. "You've got to ask: 'Is this reality?'" Bon implored the press. "No, it's not."

It may all seem unreal to Bon, but France Télécom's travails could escalate to the level of a national—if not Continental—crisis. As France's most widely owned stock, it already is dragging down the entire Paris bourse. And while there is

against state aid to companies. Besides, Paris is under pressure from the rest of the EU to rein in its budget deficit, and so would find it hard to justify—much less pay for—such a massive bailout. Even government-guaranteed bonds would be hard to get past Brussels. "They'd flagrantly contravene the European Commission, and France would rather come up with something more subtle than that," says Rick Deutsch, head of European credit research for BNP Paribas in London.

That leaves only a handful of other solutions. France Télécom was already planning to sell off about \$5 billion in assets this year, including minority stakes in other carriers and tech companies. But to really slash debt, analysts say the carrier may now have to unload bigger assets, such as all or part of Orange. Yet Orange would probably fetch far less than the \$40 billion France Télécom paid for it two years ago. Besides, the wireless carrier was the source of 92% of its parent's revenue growth and nearly 28% of operating profits last year.

The most plausible scenario is recapitalization. The government could sell some of its France Télécom shares out-

nagging question is whether the government would agree to a rights issue now. Doing so would require coming up with cash to avoid dilution; declining to participate would water down its stake and require authorizing legislation.

And what of Bon's fate? Analysts say sacking him wouldn't solve the company's current crisis. And because Bon's boss is the state, his tenure is political. He's friends with Chirac's advisor, former Prime Minister Alain Juppé, and was recruited to Télécom by the new Labor Minister, François Fillon, who authored the original legislation to privatize the company. "For the current government to get rid of him would be extremely difficult," says Cohen. However, some speculate Bon may be sent packing after the harsh medicine has been administered. Then Raffarin's team can put its own exec in place to take credit for the recovery.

Pretty tough stuff, but these are tough times. With all the simple fixes for France Télécom already exhausted, the government needs to be thinking way, way outside the box.

By Andy Reinhardt, with Stephen Baker and Carol Matlack, in Paris

e has sunk below that of its wireless holding, Orange

anger the company will shut down, weakness could hold back development of everything from broadband access to 3G wireless systems not just in France, but across Europe. Facing France Télécom is shaping up to be the first major test for the incoming center-right government of President Jacques Chirac and Prime Minister Jean-Pierre Raffarin. Although the state still owns more than 55% of the company, the new administration insists there are no plans to bail it out. But pressure from shareholders, creditors, and the company's 147,000 French employees will well force the government's hand. The rest of the Continent will be watching how Chirac & Co., who want to move France onto a more free-market basis, deal with the mess. "How are you going to convince people of the need for liberalization and privatization when you have France Télécom turning out this way?" asks Elie Cohen, a former board member and research director at France's prestigious National Center for Scientific Research.

The scope for government action is limited, however. The newly installed leadership can't offer France Télécom relief or low-interest loans without running afoul of European Union rules

right and pump the proceeds back into the telco, but it would need legislative approval to reduce its stake below 50%. Analysts think that's a long shot, in part because the state would rather sell at a higher price. Instead, France Télécom will likely undertake a rights issue, offering existing shareholders a chance to buy additional shares at a discount. Bon and the government have repeatedly rejected such an option, even though it was used successfully by carriers like BT Group and Royal KPN to get back on their feet. The

EMBATTLED

Messier still has some board support, but investors want Vivendi broken up



COMMENTARY

By Carol Matlack

HOW VIVENDI SHOULD CLEAN UP MESSIER'S MESS

We've had enough. That's what shareholders have been telling Vivendi Universal Chief Executive Jean-Marie Messier as they've driven Vivendi shares down 40% since June 1. The embattled CEO still has the support of the board. But whether he stays or goes, the market is signaling it wants Vivendi to take a blowtorch to the global conglomerate Messier tried to weld onto the chassis of an old French water company. "There is no logic holding Vivendi together. It is only a series of mistakes," says Michael C. Kraland, a fund manager at Trinity Capital Partners in Paris who dumped his Vivendi stock several weeks ago.

The company urgently needs to reduce its \$19 billion debt and simplify its structure. That means selling off a big pile of assets Messier spent billions acquiring—and, in effect, admitting his vision was all wrong. After Messier bought Seagram Co. from Edgar Bronfman Jr. and his family, the company was supposed to be a happy marriage of content and distribution. Vivendi units such as European pay-TV group Canal+ and French mobile-phone group Cegetel would provide new outlets for Seagram's Universal film and music properties. But Canal+ is losing money and retreating from markets, and snazzy new mobile-phone services remain a distant dream.

Vivendi needs to dump most of its distribution holdings and reemerge as a media content company focused on its Hollywood business and French publishing outfits. It shouldn't be hard. French media groups such as Lagardère and TF1 are already circling Canal+, and Vodafone is eager to get its hands on Cegetel. True, Vivendi won't be able to command great prices: Most analysts reckon Cegetel's value at about \$6.5 billion, half what it was a year ago. It's a shame—but there's no good reason to hold onto these businesses.

There's plenty of other baggage to unload. Analyst Mark Harrington of J.P. Morgan Chase & Co. in London figures Vivendi could raise at least \$5 billion by selling off properties ranging from phone companies in Morocco



MESSIER AND
EDGAR BRONFMAN

DOWNWARD SPIRAL

1996 Jean-Marie Messier becomes CEO of Générale des Eaux and renames it Vivendi

2000 Buys Seagram Co. and Pay-TV group Canal+ for \$34 billion

2001 Runs up more than \$25 billion debt with acquisitions such as USA Networks, Houghton Mifflin

MARCH, 2002 Posts \$12 billion loss for 2001 after \$14 billion asset write-down

MAY, 2002 Board names corporate governance oversight panel to oversee Messier

JUNE, 2002 Board stands by Messier after shares plunge to 14-year low; board ally Bernard Arnault quits

Data: BusinessWeek

and Poland to Canal+ Technologies, a business that develops software for TV set-top boxes. And Vivendi can continue reducing its stake in the utilities business, Vivendi Environment. Recent share transactions have lowered its stake to 42%, meaning Vivendi Universal no longer has to carry the utility's nearly \$15 billion debt on its books.

This is no ordinary restructuring, of course. Vivendi not only needs to

make smart moves but explain them to the markets. There, Messier has repeatedly come up short. In March he surprised investors by announcing a \$14 billion asset write-down. He stumbled into yet another firestorm on June 12, when Vivendi raised \$1.1 billion by parking a 12.6% stake in a utilities division with Deutsche Bank in exchange for a loan. The deal makes sense because Vivendi could avoid paying taxes on the money raised. But Messier made no announcement of the deal: After it was disclosed by French regulators on June 20, Vivendi shares swooned because investors feared the company was desperate to raise cash.

Given Messier's tin ear for investor relations, he may well not be the best man to oversee a radical restructuring. It could make more sense for the board to install someone else—most likely a respected French banker or business leader, since naming a non-French CEO would certainly spark a political firestorm in France.

For now, Messier is hanging on. The most recent board meeting was on June 25, a day after Vivendi shares plunged 23% on investor fears over its cash position. Although some of the seven non-French directors want Messier removed, a majority led by the eight French directors outvoted them. Even the patience of the French directors is wearing thin. Messier was clearly shaken when his close ally, LVMH Moët Hennessy Louis Vuitton's Bernard Arnault, quit the board on June 25.

Certainly, Vivendi is correct in arguing that it has been caught in a market downdraft and isn't entirely to blame for its recent market woes. Shares in its bigger rival, AOL Time Warner Inc., have performed just as badly, and kept right on sliding after CEO Gerald M. Levin resigned. But as Messier himself is fond of saying, "The market is always right, even if it's not right on every single day." Vivendi's shares have been sliding relentlessly now for more than six months. It's high time for a change.

Matlack covers French business and politics from Paris.

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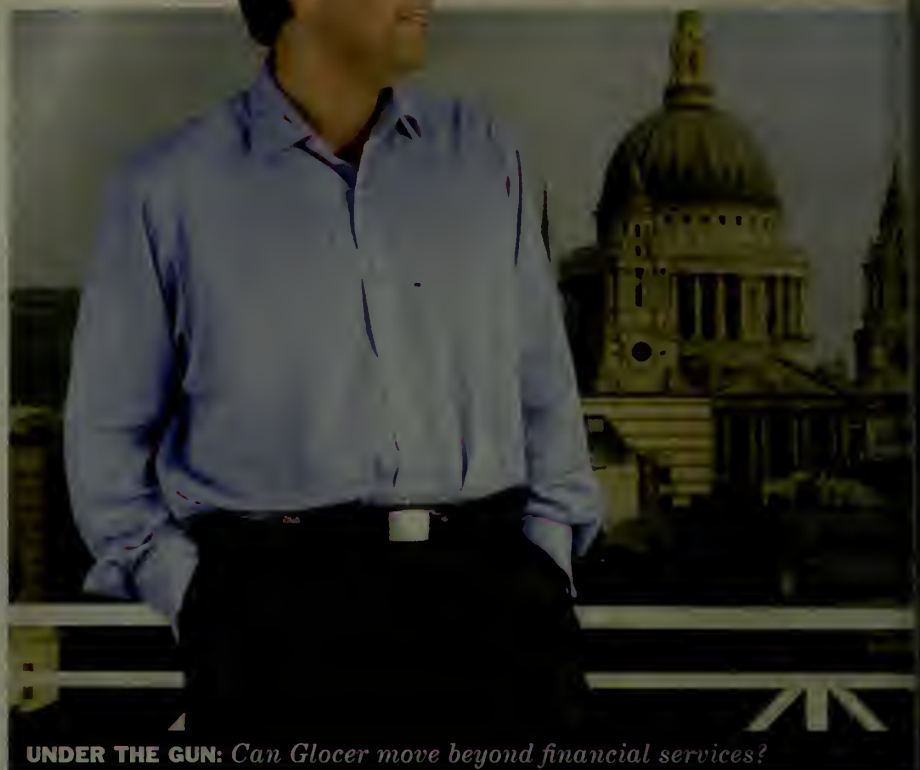
CEO Glocer keeps slicing, but investors are starting to panic

When Tom Glocer's appointment as chief executive of Reuters Group PLC was announced in December, 2000, he seemed to be getting a dream job at the top of an organization that was not only admired for its journalism but also churned out a never-ending stream of cash. Dream job? Dream on. Since taking over from Peter Job last summer, Glocer has had to rush from one crisis to another, while coping with a deepening reversal in the financial-services industry—the core consumers of Reuters data. "It's certainly a bigger challenge than I would have thought 12 months ago," Glocer says.

That's an understatement. Glocer seems extraordinarily cool when he discusses the company's woes. But there is no doubt that with Reuters' stock hitting a nine-year low in late June, he is under the gun. In part, that's because his appointment created huge expectations. Glocer, 42, a tech-savvy American lawyer, had won rave reviews running Reuters' U.S. business. So he seemed the perfect choice to squeeze fat profits out of a company that analysts thought had been too lightly managed by a succession of ex-journalists.

Now that Glocer has shown signs that he is not a miracle worker, investors are in a panic. On June 20, Glocer announced 650 job cuts on top of the 1,800

Reuters had already promised. Investors, fearing that revenue was falling faster than expected, pounded the stock. "It has been such a poorly managed company for decades, we were surprised that more cost savings weren't coming through," says Michael Nathanson, European media analyst at Sanford C. Bernstein & Co. in New York. Analysts also worry that development costs for new generations of products and services based on the Internet are getting out of hand. Nathanson estimates that



UNDER THE GUN: Can Glocer move beyond financial services?

Reuters will spend \$680 million on this over four years.

Roaring markets through early 2000 hid a spectrum of sins at many companies, Reuters included. Instinet Group PLC, the company's 83%-owned electronic-brokerage subsidiary, contributed handsome profits. And investors thought Reuters had potentially huge businesses in its Greenhouse Fund venture-capital subsidiary and TIBCO Software Inc., a 42%-owned business-software provider.

Moreover, the core business of providing trading screens to the financial-services industry

BAD SIGN: Profits are off, with no upturn in sight

was bubbling along despite its outdated products.

But how quickly the world changed. Last year, operating profits fell by 27%, to \$453 million, on revenues of \$5.8 billion. The Greenhouse Fund lost \$217 million as its once hot technology investments soured. In recent months, Instinet has come under severe pressure as competitors chew away at its once dominant market share. All of this puts more pressure on the core screen business, which is weakened by the downturn in the global securities industry. Reuters managed to increase subscription sales in the first

quarter by a slight 4%, to \$1.05 billion but its chief competitor, Bloomberg Financial Markets, is coming on strong.

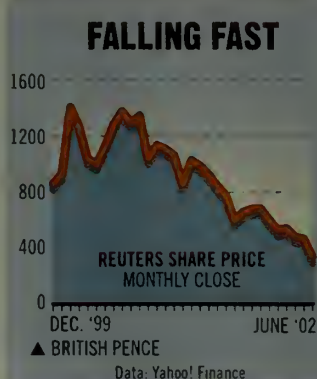
Glocer insists that "we've come a way," but that "the market has not given us credit for it." He is not banking on any quick upturn, however. In fact, he thinks that subscription revenue will decline by up to 3% in the second half, with the drop accelerating in the second, to 5% to 6%.

He's also attacking the problem at Instinet. In April, Instinet CEO Douglas M. Atkin resigned under pressure. Then in June, Glocer helped orchestrate the acquisition of Instinet's most formidable competitor, Island ECN Inc., for \$1.2 billion. The merger gives Reuters a hammerlock on the ECN business and brings Instinet a proven manager in Island's chairman, Ed Nicoll, who will become CEO of the combined company when the deal closes.

Glocer has lots of other ideas. He wants to boost Reuters' software-and-consulting business, which now counts for about 7% of revenues. He wants to reduce Reuters' dependence on the financial-services industry, which accounts for 89% of sales, by selling more products to nonfinancial companies.

But diversification moves like that will take years to pan out. For now, Glocer is hostage to the market. If they don't behave, he'll be forced to keep slashing. It's a role that could be played on the nerves of the calmest of CEOs.

By Stanley Reed in London



REUTERS



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COMMENTARY

By Brian Bremner

RELAX: JAPAN WON'T BRING ON FINANCIAL ARMAGEDDON

In global finance, it has long been the sum of all fears.

What if one of Tokyo's \$1 trillion money-center banks keels over, triggering a cascade of other failures among Japanese companies and lenders. Banks, life insurers, and companies frantically shore up their balance sheets by cashing out their U.S. Treasuries and stocks, causing the dollar to crater and U.S. interest rates to spike. Big Japanese lenders default on their end of complex derivative transactions, exposing U.S. and European banks to horrendous losses. Chaos ensues.

That prospect is why big guns in Washington such as Treasury Secretary Paul H. O'Neill and Federal Reserve Chairman Alan Greenspan nag Tokyo about fixing its decade-long banking crisis before it's too late. With signs that Prime Minister Junichiro Koizumi's government has lost interest in reform, the calls have become more shrill. "The time for half-measures and postponement has passed," warned O'Neill last month.

But Japan keeps taking its own sweet time. Does that mean the global financial system is headed toward the cliff? Not a chance. Since the late 1980s, when Japanese banks dwarfed Western rivals and had a big international presence, most have quietly retrenched from foreign markets. And foreign banks have strictly limited their exposure to Japan. So a banking collapse "would have no future impact on the global economy," says Pascal Nguyen, research director at WBP Financial Integrator, a Tokyo consulting firm.

Retrenchment, of course, does not mean a return to health: Japanese banks are sick puppies. Koizumi's promise to clear out the lion's share of their nonperforming loans—an estimated \$600 billion to \$1 trillion—by



2005 looks like a nonstarter. And the big equity holdings of Japanese banks, which count as capital, make them vulnerable to market swings, such as the 11% drop in the Nikkei since mid-May. But if the debt bomb drops, "fallout on the regional and global financial system seems manageable," according to the International Monetary Fund's global financial stability report in June.

Take U.S. Treasuries. The Japanese do own 27% of the \$1.2 trillion in Treasury bills, bonds, and notes held by foreigners, but other big players such as Britain, Germany, China, and the deep pool of U.S. pension and mutual funds, could pick up the slack

if the Japanese pulled out. Also only the most cash-strapped Japanese banks would forsake the healthy returns on U.S. Treasuries. And foreign investors hold only a measly 5% of Japan's \$4 trillion bond market, which could take a beating if the Japanese sold their domestic bond holdings to raise cash.

As for the stock market, a bank-induced crash in the Nikkei would hurt but wouldn't be catastrophic. Back in 1990, the Japanese markets represented 30% of global market capitalization. Now it's only 10%. And there are only 36 foreign companies listed on the first section of the Tokyo Stock Exchange, vs. 127 in 1990.

What about the loans foreign banks made to highly indebted Japanese companies that could get cut off at the knees by their cash-strapped domestic bankers?

Well, in a two-year period ending last September, international banks' loans outstanding to Japanese borrowers fell by 16%, to about \$513 billion, and the loans are mostly to blue-chips with strong balance sheets. As for the big, highly leveraged derivatives deals that might leave foreign banks burned if a Japanese counterparty bank defaulted, Japanese banks represent only 10%, or \$100 billion, of that market.

It's true that by dithering over its banking mess and keeping its economy in low gear, Japan is robbing the rest of the world of potential trade and investment. O'Neill figures that

Japan sacrificed \$5 trillion worth of economic output over the past decade by growing an average of 1% instead of 3%. But forget those overwrought predictions of a global market firestorm touched off by a failure in Japan's financial system. It just isn't going to happen.

Bremner covers Japanese finance from Tokyo.

WHAT IF JAPAN'S BANKS REALLY COLLAPSED?

MYTH

- A massive capital repatriation by big Japanese investors would trigger a U.S. bond-market collapse.
- A stock-market crash would wipe out global investors and pull down bourses around the world.
- Foreign investors would suffer if the bond market, the world's second-largest, collapsed.

REALITY

- Japan certainly wouldn't dump its entire \$332 billion in holdings. Other investors would pick up the slack.
- The market has shrunk from 30% of the global equity market in 1990 to 10% now.
- Global investors have only a 5% stake in Japan's \$4 trillion market.

ED BY ROSE BRADY

VENEZUELA: WHY CHAVEZ COULD NOT BE GONE—AGAIN

Unbattered Venezuelan President Hugo Chávez is taking no chances. Two months after a short-lived coup removed him from power for 48 hours, the former army paratrooper has installed anti-aircraft batteries around the presidential palace, citing fear of "bold aerial action" against him. He has purged the military of some 50 disloyal officers. Chávez has reason to worry. Not only is dissension rife in the army, but opposition politicians are plotting legal moves to get at the fiery left-wing populist. They're trying to change the constitution to shorten Chávez' six-year term, which ends in 2007. They're working to gather nearly 2 million signatures needed to call a referendum on whether new presidential elections should be held. And they're hoping to impeach Chávez for allegedly misappropriating \$2 billion from an oil-windfall fund, among other charges. Meanwhile, the Venezuelan bolivar has plunged against the dollar this year and the economy is expected to contract by 4% by yearend. The political tension could boil over at any time. One trigger could be the annual July 5 promotion of military officers, when Chávez is expected to reward those who helped return him to power in April after the deaths of 18 people in an opposition protest sparked his arrest. Another could be a massive protest by opposition politicians and labor leaders calling for July 11, the three-month anniversary of the failed coup. "The opposition's strategy," says Kelly, director of the public policy center at the Institute for Advanced Studies in Administration in Caracas, "is to maintain a high level of tension and wait for Chávez to do something stupid—like shut down a TV station." Such an authoritarian move by Chávez could push Congressional fences to cast their votes for his impeachment, or galvanize movement within the armed forces to remove him. Venezuela's opposition polls insist they will act according to



CHAVEZ: Intense pressure

the constitution. "We are seeking an institutional, nonviolent exit for President Chávez," says Edgar Zambrano, an opposition congressman. But some analysts wonder how effective that approach will be. "The opposition has to realize that if they find a constitutional way [to remove him], the President won't accept it," says retired General Fernando Ochoa, an independent military analyst who served as Defense Minister and Foreign Affairs Minister in the early 1990s. "Either the people will take to the streets, or it will be the armed forces." Some Chávez supporters have joined neighborhood groups that are believed to be armed and ready to oppose another coup.

Is there a way out of the crisis for Chávez? He recently asked former U.S. President Jimmy Carter, who was an observer of recent Venezuelan elections, to consider serving as a mediator. The Bush Administration, widely criticized for its initial acceptance of the April coup, is backing the idea. "We will not accept any undemocratic resolution of this crisis," says an Administration official. If mediation doesn't work, Chávez has other cards he can play. His Fifth Republic Movement party holds a slim majority in the National Assembly and could block an impeachment effort. And with his rating around 40%—down from a high of 80% three years ago—Chávez figures he could still win a referendum on his presidency. "I may even convoke it myself," he declared in a TV address on June 23.

Whether Chávez stays or goes, Venezuelans seem anxious for a fast resolution. "The uncertainty is killing us," says Martha Da Soza, owner of a Caracas grocery store that is emptied of staple goods every time a coup is rumored. "We've had enough. Something has to happen," she adds. For more and more Venezuelans, the question isn't what, but when.

By Geri Smith and Stephen Izer in Caracas, with Stan Crock in Washington

GLOBAL WRAPUP

MAHATHIR PICKS A SUCCESSOR

After a nail-biting three days following Malaysian Prime Minister Mahathir Mohamad's attempt to resign on June 22, Malaysia learned that his deputy, Abdullah Ahmad Badawi will take over—in October, 2003. The announcement by a government spokesman ends the anxious speculation of recent years about Mahathir's successor. By planning his retirement while still at the top of his game, 76-year-old Mahathir may avoid repeating mistakes of former Indonesian

President Suharto and the Philippines' Ferdinand Marcos, who didn't know when to quit. "He has realized it is time," says former Philippines President Fidel Ramos.

After 21 years in power, Mahathir aims to ensure his legacy by gradually handing over the reins to 62-year-old Abdullah, who is expected to continue the Premier's pro-investment policies. Recently feted by Washington as a key ally in the war against terror, Mahathir can begin to devote more time to his self-appointed role as the Islamic world's moderate voice, while play-

ing the role of elder statesman back home.

One issue for Abdullah is whether he will continue the country's longtime affirmative action plan to uplift the majority Malay population. Mahathir recently called the policy flawed, particularly the promotion of the Malay language over English. As former Education Minister, Abdullah understands the issues. But he must balance the need to remain globally competitive against the political risk of leaning too far to the West.

By Frederik Balfour in Hong Kong

Meet **ABBY JOHNSON**, third-generation scion of the family that runs **FIDELITY'S** \$1.4 trillion financial empire

BY GEOFFREY SMITH

The tension had been building for months. Abigail Pierrepont Johnson, daughter of Fidelity Investment Chairman Edward C. "Ned" Johnson III, was biding her time as second-in-command of Fidelity's \$863 billion mutual-fund unit. And by early last year, her boss, Robert C. Pozen, was under fire from some of his staff. Since 1996, Pozen, Ned's longtime confidant, had

been pushing Fidelity's high-powered fund managers to tone

down the swing-for-the-fences investing style that made Fidelity famous. "He was overbearing and controlling," says one insider. Worse yet, in the eyes of some fund managers, Pozen was a lawyer who had never managed money.

Last May, Pozen resigned abruptly and Abby—as she's called inside the company—took his job. She showered Pozen with praise. And Pozen says he decided to leave to teach at Harvard University despite a performance

review from Ned five months earlier saying "the investment department has never run better."

However, sources close to Fidelity insist that an artful coup took place. After spending 14 years training in a variety of Fidelity units to someday take over the \$1.4 trillion empire founded by her grandfather, Abby had finally exerted her power following personality clashes with Pozen. The dirty laundry was never aired in public. And, in Fidelity's closed world, that matters: The nation's largest fund company lives in constant fear of spooking its million investors.

Now, Abby, 41, is the most powerful woman in U.S. finance. She owns 24.5% of her family's private fund empire, which analysts estimate would be worth at least \$30 billion if it went public. Abby won't commit to whether she will succeed her father, 72, when he retires. Most Fidelity watchers believe she will. Friends say the Johnsons are close-knit, but that family politics won't play a role in the succession. Her brother, Edward C. Johnson IV, 37, works in the firm's real-estate unit. Her sister, Elizabeth, 39, has expressed interest in a job at Fidelity. Elizabeth's husband, Robert C. Ketterson, is an executive at Fidelity's venture-capital unit.

Her new job propels Abby to the No. 3 slot at Fidelity, behind her father and Chief Operating Officer Robert L. Reynolds, to whom she reports. It will give her crucial experience that she needs to move up later.

She is responsible for overseeing Fidelity's 280 mutual funds—the biggest of the

Finance

HERE COMES



ABBY

BIOGRAPHY

BIRTH Dec. 19, 1961 in Boston.

EDUCATION BA, art history, Hobart and William Smith, 1984; MBA, Harvard, 1988.

MARRIED to Christopher McKown, two daughters, 7 and 3.

HOBBIES Running, skiing, gardening, "playing tea party with my daughters."

WORK HABITS In by 7:15, out by 6:30, five days a week.

WHY SHE WORKS

"It's really gratifying to find something to fix or try to improve and actually see it happen."

ON PUBLICITY

"Anyone who has run money knows that blowing your own horn is usually a way of calling a top on your own performance."

ON FIDELITY'S UPS AND DOWNS

"This business will always be bumpier for us because we have such a broad range of products. I'm not trying to pick on Janus, but...when growth equities were in favor, they gained tons of share. Bond funds were in favor last year, and they don't have any value funds. It...went the other way."



THE TRADING FLOOR IN BOSTON

FIDELITY'S FRUSTRATION

ITS FUND RANKINGS HAVE BOUNCED BACK...

CATEGORY	POSITION AMONG 21 LARGEST FIRM FAMILIES	
	YEAR-TO-DATE RANK	1998 RANK
U.S. DIVERSIFIED	3	12
GROWTH FUNDS	5	5
VALUE FUNDS	4	7

...STEMMING A THREE-YEAR SLIDE IN ASSETS...



...YET MARKET SHARE KEEPS SLIPPING



Data: Financial Research Corp., Morningstar Inc., and Fidelity Investments

company's six operating units—and is also closely involved in their marketing. Abby puts in an average 10-hour day and spends most of her free time with her daughters, aged 7 and 3. "Minding the store is just what we [Johnsons] do," she says in a rare interview.

Right now, there's plenty to mind. Fidelity has been mauled by the two-year bear market, which wiped billions off its big funds—the Magellan Fund alone lost nearly \$30 billion since the market peaked in 2000. Some other funds have turned in lackluster performance. And there has been a wave of defections by fund managers, including three who left for American Express Co. in February. Obsessive secrecy about Fidelity's activities and investments, largely at Ned's behest, has hobbled the company for years. "No one in the fund industry has done a worse job of telling their story, and that has got to be hurting their fund flows" of new money coming in from investors, says Don Phillips, managing director of mutual-fund researcher Morningstar Inc. The result: Fidelity's share of U.S. equity funds—its core busi-

ness—has been in steady decline, hitting 14.8% in the quarter this year from 18.5% at the end of 1995.

Rivals throughout Wall Street are circling, stepping sales of small mutual funds with better returns; and hedge funds, so-called "separately managed accounts," aimed at wealthy clients. Vanguard Group Inc.'s popular low-cost investments have been selling more than twice as fast as Fidelity funds for over a year. Vanguard founder John C. Bogle cracks, "it's only a matter of time" before Fidelity loses its top position.

Abby doesn't give a hoot about market-share wars. Her priority is to boost Fidelity's fund performance and recapture

some of the magic from the time Peter Lynch and other stars ran them, over a decade ago. As befitted a Boston Brahmin, she has a four-pronged strategy, low key. She's trying to revive the best of Fidelity's old stockpicker culture, telling fund managers she wants them to take "smart risks" considering a wide range of investment possibilities, such as foreign stocks, to boost returns.

She's promising to give managers bigger bon-



"If you keep saying, 'I'll never [invest in one part of the market], the odds you'll do well will be limited'"

—PETER LYNCH
Fidelity vice-chairman

they beat stock-market indexes and their peers over the haul—a move that could also stem defections—and to cut of underperformers. She's planning to market value, and international funds more heavily to round out Fidelity's growth offerings. And managers will be allowed to more often with the press about individual stocks—a in Fidelity's bunker mentality.

though Abby is no Howard Hughes-style recluse, her ungling has made her one of the world's most self-effacing naires. The reserve is in the genes of a blue-blood, New and Yankee family with roots in Boston commerce going to the early 1800s. She was raised, says James C. Cur-a Fidelity vice-chairman who has counseled her since she a teenager, to keep out of the public eye and let the re-speak for themselves.

While top executives of lesser companies live in mansions fly around in private jets, Abby lives in her grandfather's st, two-story colonial-style home on a well-traveled road burban Boston. Her husband, Christopher J. McKown, is dent of Health Dialog Inc., an online health-care company

w blocks from Fidelity. own a second home on tucket island, a four-bed- antique squeezed between other houses on a narrow t, which they bought in for \$1.3 million. "The fam-philosophy is: 'Why be vy? It will only draw at-ion to yourself,'" says es H. Lowell III, whose ly owns a summer home Ned's three-bedroom Cape he beach in Nahant, north oston.

lthough she now commutes Mercedes wagon, Abby e herself to work each day n old Dodge Durango on on's Southeast Expressway ears. Once, when she was months pregnant, she ed aide Bart A. Grenier to she had a flat on the high-. "I was incredulous—I d her why she didn't just BostonCoach [a big limou-service owned by by Fi-y]," Grenier says. "Abby said she'd be late to a ting."

he eldest of three children, y got her first taste of king at Fidelity answering omer-service phones after uating from high school in . Earlier, she had summer as an assistant waitress says she never made full (ress) and T-shirt vendor. joined Fidelity full-time at 28 after earning an MBA Harvard Business School. e then, she has followed ely in her father's foot-s. Like Abby, he appren-d at Fidelity for years un-his father, Edward C. nson II, who founded the

company in 1946, taking over when he retired in 1977.

She began as an analyst covering the industrial- equipment industry. Dozens of models of trucks and bulldozers, mementos of that time, still litter her corner office in the building that houses equity managers, two blocks from Fidelity's downtown Boston corporate headquarters. Apart from pictures of her children, they're the only decorative touches.

From the get-go, she put in long hours and was chided by high-ranking fund managers

if she picked a poor stock—a hazing every young analyst at Fidelity undergoes, says a former colleague. "She put her nose to the grindstone and got into the mud with the rest of us," the colleague says.

Abby sharpened her talents managing a series of six different mutual funds over the next nine years. After her three-year stint at the Select Industrial Equipment Fund, her assignments included running the Dividend Growth Fund, the OTC Portfolio, and the Fidelity Trend Fund. Her funds produced strong, but not spectacular, results.

As a manager, Abby shares her father's "intense, paranoid drive to make sure the standards of excellence at Fidelity are unattainable by any other fund family," says Lowell, who also publishes the *Fidelity Investor* newsletter. Like her father, she shuns publicity. Despite her wealth and power, she is almost unknown to the outside world. While Pozen enjoyed the limelight, Abby never speaks at public events. And although she has received hundreds of interview requests, she rarely talks to the press—or directly with Fidelity investors. "For me, trying to run this organization takes all of my time," she says.

That busy schedule doesn't leave space to entertain Fidelity's troops as her dad does on occasion. For the company's annual Christmas "follies" a couple of years ago, the elder Johnson put 25 live frogs on his desk and videotaped a spoof ad for a fictitious Internet company called Frog.com. The name was a reference to a famous Fidelity symbol. Little frog statues grace the lobby of Fidelity's executive suite because the animal was once used as the advertising symbol for Fidelity money market funds with the acronym "Fidit." Although Abby once sang in a follies choir, she prefers to take a backseat.

In her personal dealings, Abby is quick with a smile, exceedingly polite, and articulate—though she plays her cards close to the vest even

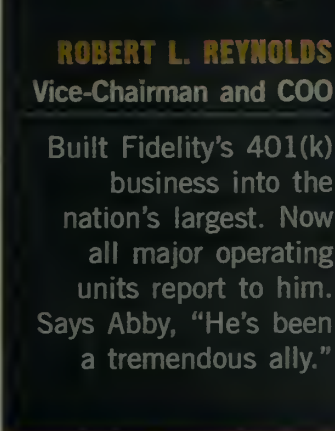
Finance

THE HIERARCHY



EDWARD C. JOHNSON III
Chairman and CEO

The 72-year-old is still firmly in control of the family empire. He has no plans to retire soon but has been grooming daughter Abby to succeed him.



ROBERT L. REYNOLDS
Vice-Chairman and COO

Built Fidelity's 401(k) business into the nation's largest. Now all major operating units report to him. Says Abby, "He's been a tremendous ally."

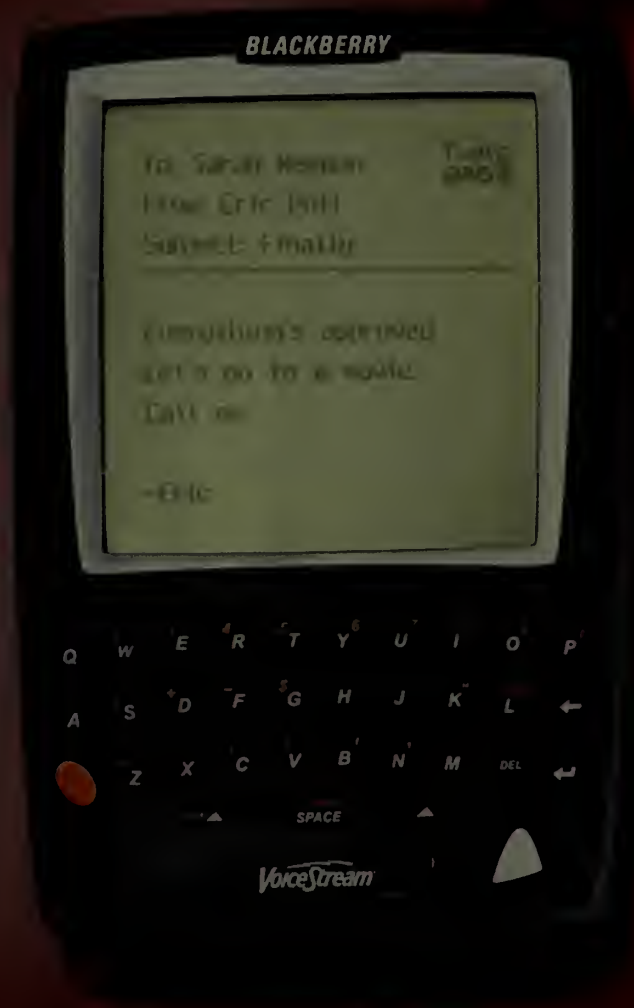


ABIGAIL P. JOHNSON
President, Fidelity Management & Research

Spent 14 years preparing to take over from her father, but there has been no official decision yet: "Looking ahead isn't going to help me do my job now."







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Abby parts company with her father's aggressive management style: She prefers to exert gentle pressure

around her closest colleagues. She exerts gentle pressure to get what she wants, while her father can be downright vindictive. For example, earlier this year, when American Express stole four of Fidelity's top fund managers, he retaliated by dropping Fidelity's corporate credit-card and travel-service business with AmEx. She prefers one-on-one meetings and

Finance

small groups and mostly listens, says Grenier. She never barks orders, but can be forceful. Despite objections from her staff, Abby insisted that Fidelity should allow customers to access their money-market funds the day after September 11 even though the stock market was closed and the securities the funds held could have lost value.

Where she really parts company with her dad is over management style. Ned, a collector of Asian art, follows the precepts of *kaizen*, a Japanese philosophy of gradual but steady improvement. Abby, who's into contemporary art, sports a modern skepticism about such ideas. "Sometimes," she explains, "you can gradually improve things. But sometimes, they don't work, and you've just got to just say: Let's grind this baby to a halt." Nor does she share her father's tendency to obsess over details, such as choosing lighting fixtures for a new building. "It's a mistake for any manager to delve into the details on everything," she says.

All the same, Abby has yet to show the same entrepreneurial skills as her father. "Ned has great insight—the ability to see things in the market and figure out where Fidelity should go, but I haven't seen her ability to see things yet," says a senior Fidelity executive. Although she has a huge pool of seasoned managers to fall back on, that may eventually become a problem for Abby.

In her first year overseeing Fidelity's fund unit, Abby is attempting to set a new direction. Under Pozen, Fidelity developed an investment approach that was a reaction to blowups in many of its big funds in 1995. Then, some high-profile funds, including Magellan, took huge bets in bonds and cash that failed to pay off. But the changes were also a concession to the demands of 401(k) plan investment advisers, who account for more than half of Fidelity's business and who want funds to stick to their announced investing style. Pozen divided Fidelity funds into "go-anywhere" funds and style-specific funds that had to hew closely to their mandates. Blue Chip Growth fund, for example, could buy only blue-chip stocks instead of picking up no-name small caps, as its former manager, Michael Gordon, had done.

Pozen also tried to tackle problems associated with running funds with billions of dollars in assets. Large funds can't

make much money buying small and illiquid securities because they can't own enough of them to make a big difference in their performance. So, many were targeted toward large cap stocks, and managers were given new tools to measure they knew where they stood against market indexes such as the S&P 500—a system called benchmarking. Says Equity Income fund manager Stephen Petersen: "The last half of the 1990s was all about looking at how you were positioned relative to your benchmark."

Though Pozen brought discipline to the funds, many still worry that Fidelity's gigantic size condemns it to making middle-of-the-road returns over the long haul. For example, the \$72 billion Magellan fund, Fidelity's flagship, beaten the S&P 500 in just two out of the past five years, but it's again trailing this year. "Fidelity funds are not getting

trouble the way they did in the past, but they're also not the performance leaders," says A. Michael Lipper, president of Lipper Consulting Services Inc. Rival Bogle adds: "The old Fidelity is gone forever—they just can't do what they did with nearly \$1 trillion what they did with \$100 million."

Some investors avoid Fidelity funds because they think they have a better chance of making more money through smaller investment firms. "I don't recommend them anymore for any of our clients," says Minneapolis financial adviser Michael Hellfrich. He invests in funds that don't face the same problems of size, such as Longleaf Partners International and Tweedy, Browne Global Value.

Despite the sniping, Abby isn't about to dump Pozen's benchmarking system. Rather, she wants to have her cake and eat it, too, by keeping the discipline imposed but revitalizing it with a bit of Fidelity's old stockpicking flair. Her push for managers to take more risks, but smart ones. She concedes that's quite a tall order. "It's never obvious what a smart risk is, which is why we hire smart people," she says. Essentially, say aides, she wants managers to consider a broader range of investment options than before, including emerging market stocks, precious metals, casino or other types of equities they might otherwise not have considered.

The approach is hardly radical. "I wouldn't say there have been huge

changes," says Dividend Growth fund manager Charles Mangum. Indeed, many outsiders say that apart from high cash levels in some funds, Fidelity funds have made no big investment shifts in the past year.

But Peter Lynch, now a Fidelity vice-chairman, former trustee, occasional adviser to Abby, and tutor for new analysts recruits, thinks she's on the right track. The flexibility Abby wants to build back into stockpicking is "the single most important thing" fund managers need to be able to beat the market. "If you keep saying I'll never [invest in a certain pe



Private by nature, Abby is uncomfortable being in the public eye

WITH HER HUSBAND AT A GALA



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of the market], the odds you'll do well will be limited."

Certainly, some of Fidelity's fund returns have perked up a bit compared with the competition. Although its 22 signature growth funds have lost an average of 13.09% in the year to date, that was the third-best performance among the top 21 fund families and up from third place for the 12 months ending June 21, according to Morningstar. Fidelity's 81 diversified domestic equity funds were down 9.18%—placing Fidelity fifth among the top 21 this year.

But Abby's plans to win back customers by emphasizing Fidelity's product range, including value, bond, and international funds, have run into some flak. Skeptics question her timing, since such funds have been popular for the last year. Starting to push them now would be "the Pentagon approach of fighting the last war brilliantly rather than looking ahead," Lipper says.

But to Fidelity executives, it's just part of the company's constant crusade to broaden its business. COO Reynolds says Fidelity's fund business is just one piece of the firm's giant investment and marketing machine. Last year, less than half of Fidelity's \$1.3 billion in profits came from Fidelity managed funds. The rest came from selling other funds—including Vanguard's—through its brokerage business, plus a broad array of services that are not dependent on the direction of the market.

Fidelity's fastest-growing business is human-resources outsourcing, which involves handling the back-office computer work for corporate benefits plans. Philip Morris, Hughes Electronics, Ford Motor, and Shell are among its top customers. "Many people just watch our fund flows, but our business model gives us far more growth drivers than anyone realizes," says Fidelity Chief Financial Officer Stephen P. Jonas. Reynolds and Jonas profess to care less about Fidelity's equity-market share. "In this business, market share constantly ebbs and flows," Jonas says.

It may be that Fidelity's funds are not as central to the core business as they once were. Still, they are crucial to the firm's future. Abby Johnson has a tough balancing act trying to restore some of the old Fidelity bravado with the need for caution demanded by a huge customer base frightened by the bear market. However, her biggest risk may be forgetting what made Fidelity Investment great: creative, aggressive, high-profile funds. She needs to make sure Fidelity's funds don't just become obscure cogs in a huge machine. The pressure is on. Fidelity's 14-year reign as the nation's largest fund company is on the line. ■

Information Technology



THE INTERNET

ORBITZ' HEAVY BAGGAGE

Why it's unprofitable—and why the IPO may have to wait

When Orbitz Inc., the Web travel agency owned by five of the nation's biggest airlines, filed financial documents with the Securities & Exchange Commission to go public in May, investor reaction ranged from respectful to giddy. After all, Net travel site Expedia Inc. and discount hotel-room player Hotels.com have shown that the business can be solidly profitable. "Expedia has been a really hot company and a good invest-

ment," says William Smith, president of IPO Plus Fund in Greenwich, Conn. Orbitz is a nameplate IPO, and it will hot deal."

Maybe not. An examination of Orbitz's newly disclosed financial information raises questions about the company's prospects. For starters, it still loses money—\$8.9 million in the first quarter of sales of \$32.2 million—even though other public Web travel companies are profitable. And Orbitz could have tro-

wing its way to the level of profitability that Expedia and Hotels.com e. The SEC filings reveal that Orbitz' contracts with the company's five founding airlines call for the per-ticket commission rates the airlines pay Orbitz to 15% to 30% annually through 2007. Worse, Orbitz is running low on cash. It had only \$39 million as of Mar. 31. The company expects to raise \$125 million in its offering, but the IPO market has cooled considerably since Orbitz filed with the SEC. Without new money, Orbitz could face a cash crunch as early as next year. "I think the reason Orbitz is going an IPO is that it has no other choice," says Philip Wolf, president of travel consulting firm PhoCusWright Inc.

Nonsense, says Orbitz. Jeffrey G. Katz, the company's chairman and chief executive, makes the case that Orbitz is healthy. He says the summer travel season and Orbitz' rising sales of hotel rooms will head off any cash squeeze, with or without the offering. He also says Orbitz will have at least one or two more quarters of financial results to show its growth plans are working before it goes public. "When we're on our feet and showing, we'll have a lot to answer questions" about growth, he says.

Still, Katz may face tough sell once investors understand how Orbitz' corporate governance is structured. The company was set up by United, American, Delta, Northwest, Continental, and other airlines will control nine board seats

for the IPO. Katz says the airlines have vested interest in Orbitz' success. But the partners' control raises questions about possible conflicts of interest. If the interests of the airlines and Orbitz' other shareholders diverge, which group will Orbitz try to satisfy?

The SEC filings suggest that so far, the airlines are the top priority. Examining Orbitz's decision, implemented last September, to begin charging consumers \$5 per ticket reservation fee—a charge its rivals, such as Expedia, don't levy. That fee serves a long-standing goal of the airlines to shift more of their distribution costs to consumers.

But the \$5 fee could hurt Orbitz' popularity. While the company has positioned itself as the lowest-cost travel

site, consumers are finding that's typically not the case these days. In a June 6 report, *Consumer Reports* wrote that Expedia, not Orbitz, is now the low-price leader for airfare. A *BusinessWeek* analysis of 10 hypothetical weekend jaunts reached a similar conclusion: Including the \$5 fee, Expedia was cheaper than Orbitz for eight trips, while Orbitz was less expensive in two cases. That's dangerous because Forrester Research Inc.'s analysis shows that 6 out of 10 customers aren't loyal to any one travel site. "You're only as good as your last deal," says Forrester analyst Henry H. Harteveldt. Katz says the fee has not cost Orbitz market share.

A more important strategic lapse is Orbitz' failure, so far, to enter the most profitable part of the travel business. Instead of simply selling airline tickets and hotel rooms for commissions, successful sites such as Expedia also use what they call a "merchant model." They negotiate

for hotel rooms or airline tickets. "The merchant business is not so great for airlines," says analyst Mark Rowen of Prudential Securities Inc. Katz says Orbitz will get into the merchant business eventually. Meantime, the company started into the business indirectly in June: It began listing hotel rooms on its Web site that are offered by Travelweb.com, a hotel-industry-backed merchant site that pays Orbitz a commission for each sale.

Certainly, there are reasons to like Orbitz' prospects. Launched last June, the Chicago-based site sold \$542 million worth of travel in the first quarter, making it the third-largest online agent, behind Expedia and Travelocity.com Inc. Orbitz began with one big advantage: access to special low-cost fares that were available only on Orbitz and the airlines' own Web sites. Those "Web fares" terrified rivals, who are trying to get them declared an antitrust violation. The Transportation and Justice Depts. are

evaluating the claims, and a report from Transportation is due by July 1. But, analysts say, Expedia and Travelocity now get most of the Web fares that Orbitz does.

Katz argues that Orbitz can overcome the business and antitrust challenges it faces. He has high hopes, in particular, for a technology, set to be introduced later this year, that will overhaul the arcane economics of selling airline tickets. Right now, travel agencies rely on technology from companies such as Sabre Holdings

Corp. to sift through the airlines' ever-changing fare schedules to find itineraries. Airlines pay about \$10 per ticket to let travel agencies conduct such searches. Katz says that Orbitz' new technology, called supplier link, will let the airlines cut out Sabre and its peers. Orbitz and the airlines plan to split the savings from such fees, which total about \$1.5 billion each year.

With all its challenges, Orbitz may have a hard time living up to its billing as a hot IPO. Even Katz says he may not rush to go public. "When we go public is a function of when the timing is right," he says. Holding off may make the most sense for Orbitz—and for investors.

By Timothy J. Mullaney
in New York

ENGINE TROUBLE

At first blush, the Orbitz IPO seems likely to benefit from the success of Expedia and other online travel players. But Orbitz is losing money. A look at where it gets its revenues tells the story:

AGENCY FEES AND COMMISSIONS

Orbitz' IPO filing shows that the per-ticket fees it gets from airlines will fall in coming years. Orbitz hopes to make that up with new businesses, such as running Web sites for airlines.

RESERVATION FEES FROM CONSUMERS

In December, Orbitz added a minimum \$5-per-ticket fee on air travel, up to \$10 per reservation. The fees often make tickets from Orbitz more expensive than those from Expedia, undercutting the marketing message that it is the low-cost travel site.

MERCHANT BUSINESS

Expedia makes most of its money by buying hotel rooms and vacation packages at a bulk rate and reselling them at a higher price, leading to much higher profits. Orbitz hasn't gotten into this part of the business yet.

ORBITZ	EXPEDIA
72%	45%
19	0
0	50

Figures are the percent of revenues in the first quarter of 2002. Data: Securities & Exchange Commission filings

discount prices for large blocks of hotel rooms or vacation packages, then mark up the prices and sell them to consumers. Although travel agencies forego commissions, the merchant model is far more profitable because a typical \$6 airline ticket commission is dwarfed by markups that can hit \$500 on a vacation package. Orbitz had no merchant-model revenue in the first quarter, though it's inching into the business. "That decision came back to bite them on the tuchus," says Phil Carpenter, vice-president of travel-shopping service SideStep.

Analysts chalk up Orbitz' slow entry into the merchant business to airlines' resistance. Why? The key to success in the merchant model is for the travel agency to force down the price it pays

Cover Story

It's the world's most prestigious consulting firm. But it helped create Enron's high-risk business model. Some of McKinsey's other clients haven't fared so well, either: Kmart, Swissair, and Global Crossing. What's happening?

BY JOHN A. BYRNE

Shortly after Enron Corp. tumbled into bankruptcy last December, McKinsey & Co. Managing Partner Rajat Gupta was worried. It wasn't only because former Enron CEO Jeffrey K. Skilling was once a McKinsey & Co. partner and loyal alum. Or that his firm had advised the giant energy trader for nearly 18 years on basic strategy, even sitting in on boardroom presentations to Enron's directors. Or even that many of the underlying principles of Enron's transformation, including its "asset-light" strategy, its "loose-tight" culture, and the securitization of debt, were eagerly promoted by McKinsey consultants.

Gupta was worried about something much more immediate:

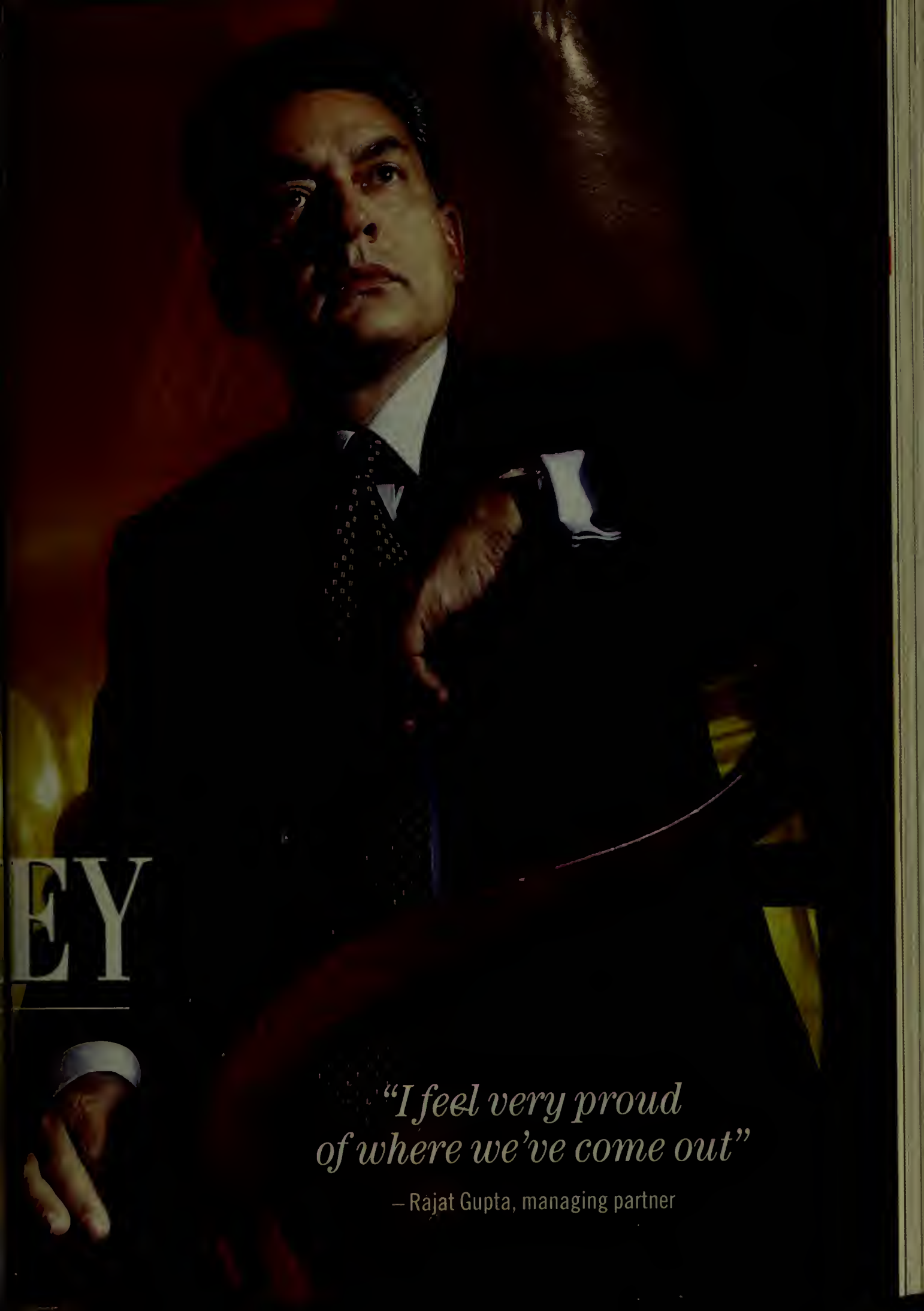
INSIDE

McKinsey

Had McKinsey crossed a legal line that would drag it into the unfolding morass? In a stunning exercise for the world's whitest of white-shoe management consultants, Gupta dispatched his chief legal counsel to McKinsey's offices in Houston to review the firm's work at Enron. The mission was to find any evidence linking McKinsey to the massive fraud behind Enron's business model.

The lawyer came back with good news: There were no shredded documents, à la Arthur Andersen LLP, and, more important, says Gupta, there was nothing in the files to show that McKinsey ever helped Enron engineer its controversial off-balance-sheet financing or its financial reporting strategy. "In all the work we did with Enron," maintains Gupta,

CHRIS WADE



EY

*"I feel very proud
of where we've come out"*

— Rajat Gupta, managing partner

“Could they have seen [Enron] malfunctioning?”

“we did not do anything that is related to financial structuring or disclosure or any of the issues that got them into trouble. We stand by all the work we did. Beyond that, we can only empathize with the trouble they are going through. It’s a sad thing to see.”

Still, outsiders marvel that the secretive partnership has not been drawn into the debacle, given its extensive involvement at Enron. “I’m surprised that they haven’t been subpoenaed as a witness, at least,” says Wayne E. Cooper, CEO of Kennedy Information, a research and publishing firm that keeps tabs on consultants. “There was so much smoke coming out of the Andersen smoking gun that all the firefighters went after that one. McKinsey was lucky. They dodged a bullet.”

The bad news, however, is that Enron, which was

Did McKinsey’s partners get caught up in the euphoria of the late ’90s and suffer lapses of judgment? And if so, what does that say about the quality of its expensive advice? Did it stray from its core values? What accountability does it have as any consulting firm—have for the ideas and concepts it launches into a company?

After all, McKinsey was a key architect of the strategy thinking that made Enron a Wall Street darling. In books, articles, and essays, its partners regularly stamped their imprimatur on many of Enron’s strategies and practices, helping position the energy giant as a corporate innovator worthy of emulation. The firm may not be the subject of any investigations, but its close involvement with Enron raises the question of whether McKinsey, like some other professional firms, ignored warning flags in order to keep an important account.

The breakdowns of such visible clients could not have come at a more troubling time. Instead of celebrating the end of his tenure, the firm’s final three-year

MCKINSEY OVER THE YEARS



1926 University of Chicago accounting professor James “Mac” McKinsey founds the firm. First client: meatpacker Armour & Co.

paying McKinsey as much as \$10 million in annual fees, is just one of an unusual number of embarrassing client failures for the elite consulting firm. Besides Enron, there’s Swissair, Kmart, and Global Crossing—all McKinsey clients that have filed for bankruptcy in relatively short order. And those are just the biggest. McKinsey also finds itself improbably lining up with other creditors to collect unpaid fees from recently bankrupt companies that soared during the late ’90s only to crash later. Battery maker Exide Technologies and NorthPoint Communications Group Inc., an upstart telecom provider, are two such examples.

All of which raises uncomfortable questions about the world’s most prestigious—and enigmatic—consulting firm.



1933 Marvin Bower, a lawyer and Harvard MBA, joins the New York office and essentially invents the discipline of modern management consulting.

1935 Marshall Field & Co. becomes the firm’s first big client and eventually hires James McKinsey to be CEO.



1959 Opens first non-U.S. office in London and wins landmark assignment with Bank of England.

1960s Successful expansion overseas throughout Europe and Australia.

as managing director, Gupta, 53, finds his firm roiled by a rare and potentially disruptive downturn in its business. Like most other consulting firms, McKinsey rode the e-business wave to record revenues—and record partner payouts—in 2000. When the boom turned to bust, the firm was stuck with far too many consultants and not nearly enough assignments. The utilization rate, or billable time, of its consultants has fallen to its lowest level in more than 32 years: just 52%, vs. the heady 64% enjoyed during the dot-com boom.

That’s not to say that McKinsey has lost its standing. The firm remains the high priest of high-level consulting, with

MID-1970s New strategy consulting boutiques and Consulting Group and offer first intense competition in high-level strategy consulting.



becomes CEO of RJR Nabisco and IBM. Other alumni head some of the world’s biggest companies.

1964 Launches *The McKinsey Quarterly*, which is the foremost journal of management ideas produced by a consulting firm.

spoken up? The answer is yes. — a former McKinsey consultant

st formidable intellectual firepower, the classiest client portfolio, and the greatest global reach of any adviser to management in the world. Most of the firm's top clients pay a million a year and up in fees, while McKinsey's largest client—which it declines to name—doled out \$60 million for its services last year. McKinsey serves 147 of the world's 200 largest corporations, including 80 of the top 120 financial-services firms, 9 of the 11 largest chemical companies, and 15 of the 22 biggest health-care and pharmaceutical concerns.

McKinsey partners learn early on to protect and cultivate their client relationships. The firm says that it has served more than 400 active clients for 15 years or longer. It may be the priciest of the management consultants, but longtime clients say it gives top advice. "McKinsey will bring its most senior people in to discuss the things they would do if they were in our shoes," says Klaus Kleinfeld, CEO



1990 McKinsey partner Jeffrey Skilling joins one of the firm's major clients, Enron.



McKinsey consultants and Bob Anderson publish *In Search of Excellence*.



Siemens Corp., a longstanding client. "You have lunch. You have dinner. And then projects evolve. Very often, competitive bidding doesn't happen."

Gupta shows little concern over the meltdown of high-profile clients. "In these turbulent times, with our serving more than half the Fortune 500 companies, there are bound to be some clients that get into trouble," he says matter-of-factly. "We wouldn't have as many ongoing client situations if we didn't do good-quality work." And to be fair, McKinsey is hardly the only consultant to tie up with some high-flyer startups in the '90s that later crashed.

When he became McKinsey's managing partner in 1994, Gupta's challenge was clear: He had to keep up McKinsey's

1994 Rajat Gupta becomes the first foreign-born managing partner.

1994-97 Gupta accelerates global expansion, opening offices in Shanghai, Bogotá, Moscow, Beijing, Perth, Bangkok, Kuala Lumpur, and Singapore.



growth while ensuring that size would not destroy the ethos of the close-knit partnership or undermine the firm's guiding principles. McKinseyites refer to these precepts, laid down by the firm's early leader, Marvin Bower, with near-religious conviction. Among the high-minded goals: Hire the best people and urge them to always put the client first—ahead of the interests of the firm.

In Gupta's early days as managing partner, some colleagues argued for keeping McKinsey small, to safeguard its culture and quality. Gupta was of another mind: He aggressively expanded abroad, opening up far-flung branches throughout Asia and Eastern Europe. In all, he expanded McKinsey's network to 84 worldwide locations from 58, boosted the consulting staff to 7,700 from 2,900, and lifted revenues to \$3.4 billion from \$1.2 billion in 1993. Meanwhile, the number of partners grew from 427 to 891. "It's a less personal place than it used to be," says Nancy Killefer, a senior partner in Washington, D.C. "In the old days, you

Cover Story



1999-2001 Three of the most recent books by McKinsey consultants sang the praises of Enron just before its collapse.

2000 The high-tech boom helps to drive annual revenues over \$3 billion for first time, making McKinsey twice as big as its nearest competitor in general management consulting.



2002 McKinsey assists Hewlett-Packard CEO Carly Fiorina (seen with Compaq CEO Michael Capellas) on HP's controversial Compaq acquisition. McKinsey earns \$9 million on deal.

knew everybody. That's not possible anymore."

Some observers believe the changes in McKinsey's culture went even deeper. Quietly, some current and former McKinsey consultants say the firm strayed from some of the ingrained values that have long guided the firm. Through the dot-com boom, for example, McKinsey allowed its focus on building agenda-shaping relationships with top management at leading companies to slip, as the firm took on some distinctly down-market clients and projects. Increasingly, McKinsey began ad-

“There was a whole group of people in the bu

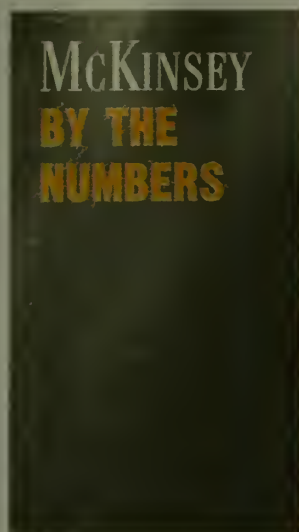
vising upstarts and divisional managers at less prestigious companies.

Worse, some argue, there was a noticeable tilt toward bringing in revenue at the expense of developing knowledge—a claim McKinsey vehemently disputes. “In [an earlier] era, the whole place had this tremendous focus on ideas,” recalls a former McKinsey consultant. “I think knowledge has taken a backseat to revenue generation. The more revenues you create, the more your compensation and standing in the firm increases.”

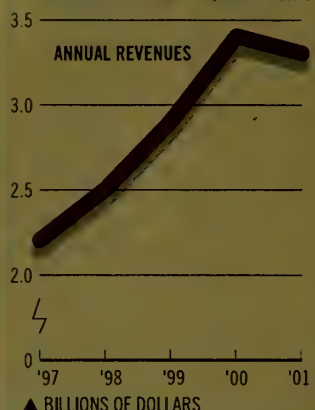
Gupta downplays any shift in priorities. “The pendulum does swing a little bit. I’d say that client development in the last year or two is more in the forefront, simply because that is the biggest need right now,” he says, using McKinsey-speak for bringing in new business.

Perhaps the most visible example of this shift, say observers, was the rise of Ron Hulme, an affable, low-key senior partner and a leader of its energy practice, who managed the Enron account from McKinsey’s Houston offices. Like many of the firm’s consultants, Hulme penned essays extolling the virtues of Enron. As McKinsey’s annual billings climbed higher and higher at Enron—at one recent point exceeding \$10 million—Hulme commanded greater influence in the firm, helping to lead partner conferences and key initiatives. Some insiders even considered him a potential successor to Gupta, though that’s now an unlikely prospect, given Enron’s collapse. “Despite his young age, he had tremendously high standing and power that derived from the Enron relationship,” says a former McKinseyite. Hulme declined to comment.

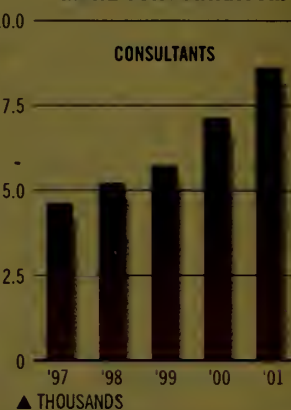
Hulme did not initiate McKinsey’s Enron business. Like many of the deepest and most lucrative corporate relationships, it began with one consultant who instantly impressed a client



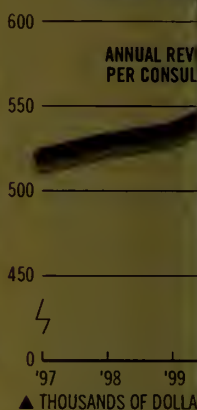
THE HIGH-TECH BOOM FUELED DOUBLE-DIGIT GROWTH...



...THAT LED TO HIRING MORE CONSULTANTS...



...BUT THE BU SLUMP HAS



Data: Consultants News, BusinessWeek estimates

with his brilliance and insights. Jeffrey Skilling, then McKinsey’s partner in charge of the worldwide energy practice, began advising Enron in the late ’80s, but the relationship was cemented when he joined Enron in 1990 with the mandate to create a new way of doing business. Skilling, who said he felt as if he were “doing God’s work” at McKinsey, had proposed that Enron create a portfolio of fixed-price purchase and supply contracts that would supposedly offset supply risks and minimize the price fluctuations of the spot market for trading natural gas.

After joining Enron, Skilling repeatedly turned to McKinsey teams for analytical help and advice. “They infiltrated Enron with Jeff, and he was just the tip of the iceberg,” says a former McKinsey consultant who worked at Enron. “There were all sorts of McKinsey people who went in over the years. They were so happy they had Enron locked up.”

Indeed, several other prominent McKinsey consultants migrated to Enron as employees, including partner Doug Vohs, who left the firm in 1994 for a four-year stint as president at Enron Capital & Trade Resources, where he led a team that developed an electric power and natural gas hedge fund. As Enron work became more financially demanding, McKinsey teams there increasingly drew on partners with expertise in trading, risk management, and investment banking. At any given time, McKinsey had as many as 20 consultants at the energy company, several stationed in Enron’s offices.

By and large, most of McKinsey’s assignments at Enron were tactical or technical in nature: doing the prep work for entering new markets, formulating strategy for new products and services, and deciding whether Enron should acquire or partner with another company to gain access to a pipeline.



McKINSEY BIG THINK

Many of the intellectual underpinnings of Enron came from McKinsey & Co. thinkers. Here’s how the firm promoted its ideas in its influential journal, The McKinsey Quarterly

ASSET-LIGHT STRATEGY

“Enron was not distinctive at building and operating power stations, but it didn’t matter; these skills could be contracted out. Rather, it was good at negotiating contracts, financing, and government guarantees—precisely the skills that distinguished successful players.”

MQ, 1997, No. 2

OFF-BALANCE-SHEET FINANCING

“The deployment of off-balance sheet funds using institutional investment money fostered [Enron’s] securitization skills and granted it access to capital at the hurdle rates of major oil companies.”

MQ, 1997, No. 2

lost their way” — Larry Mendonca, McKinsey partner

McKINSEY
ITS RIVALS
the major
management
firms, McKinsey &
wins the largest,
global, and the
—and has held
in market share
for five years
recent setbacks

FIRM	FISCAL 2001 REVENUES (BILLIONS)	CHANGE FROM 2000	MARKET SHARE AMONG MAJOR FIRMS
McKINSEY	\$3.4	-2%	40.6%
BOOZ, ALLEN & HAMILTON	1.6	4	19.1
A. T. KEARNEY*	1.2	-7	14.4
BOSTON CONSULTING GROUP	1.1	-5	12.5
BAIN	0.8	1	9.7
MONITOR	0.3	9	3.6

*A unit of EDSData: Consultants News, BusinessWeek estimates

McKinsey also helped Enron formulate its now-discredited broadband strategy, in which it built a high-speed fiber network to support the trading of communications capacity. Among other things, McKinsey, over about six months, helped gauge the size and growth of the market. And, like Enron and many others, it didn't see the telecom meltdown coming. McKinsey also helped to set up the finance subsidiary that Enron later portrayed as its growth engine, and also assisted the firm with its commodity risk management operations. A former Enron senior executive says McKinsey consultancy wielded influence throughout the organization. "They were all over the place," he says. "They were sitting with us every step of the way. They thought, 'This thing could be big, we want credit for it.'" The extent of its work there and access to senior management exposed the firm to much of Enron's inner workings. Over the years, McKinsey partners like Richard N. Foster, a senior partner, even became an advisor to Enron's board, attending a half-dozen board meetings in the 12 months up until October, 2001. Foster was frequently asked to step out of those meetings while the partnership conferred with company lawyers over confidential matters. Competitors privately gloat that the title of Foster's recent book, *Creative Destruction*, aptly captures what went wrong at Enron. Embarrassingly, the book, published in April, 2001, is filled with glowing references to Enron. "Dick Foster was very happy to see practice that enforced his theories of creative destruction at Enron," says a partner at another consulting firm. "McKinsey seems to have partners who develop academic theories and then run clinical trials on

their clients." Foster declined to comment.

Some insiders offer a less benign interpretation of what went wrong at Enron. They don't claim McKinsey did anything illegal but do suggest it might have turned a blind eye to signs of trouble to preserve a lucrative relationship. "The problem for McKinsey with Enron isn't Andersen-type issues," says the former McKinsey consultant who worked at Enron. "Rather, it's 'Could they have seen the organization malfunctioning and spoken up?' The answer is yes. When you have a mega-client, 'This is what the client should hear' is twisted into, 'This is what is going to let us stay at the boardroom level.'"

Gupta won't be drawn into a detailed conversation on Enron. "Our view is not so much to have a public point of view here,"

he says. "I won't specifically talk about our work at Enron. We're constantly assessing whether we served everybody in the right way. I think we have."

Perhaps so. But many of the intellectual underpinnings of Enron's transformation from pipeline company to trading colossus can be traced directly to McKinsey thinking. Senior partner Lowell Bryan, one of the most influential of the firm's big thinkers today, has written extensively on securitized credit—the process of converting loans or receivables into securities. As far back as 1987, just after McKinsey began consulting for Enron, Bryan was writing that "securitization's potential...is great because it removes capital and balance sheets as constraints on growth." It was Bryan, too, who has written and spoken extensively on how capital-intensive companies such as Enron can generate greater value by finding ways to run low-asset businesses—what Skilling referred to as his "asset-light" strategy. Bryan was brought into Enron to convey these ideas to the company's top 100 executives. But he insists his ideas are not to blame. "I never said anything about fraud, accounting, or any of those issues."

If McKinsey has been humbled by the Enron experience, it certainly doesn't show it. When New York headquarters asked all consultants who favorably mentioned Enron in articles whether they wanted their citations taken off McKinsey's Web site, not a single consultant said yes. So all of the nearly 30 separate references to Enron in McKinsey-authored articles remain on the site.

As things began to unravel at Enron, some other im-

Cover Story

THE STREET

has convinced Wall Street of its long-term prospects of its businesses; about half of its market cap is attributable to assets that have yet to generate earnings. As a result of this openness, Enron trades at a price-to-earnings ratio of 60, in contrast to the industry average of 14."

1, No. 1

ATOMIZATION

"Enron has built a reputation as one of the world's most innovative companies by attacking and atomizing traditional industry structures—first in natural gas and later in such diverse businesses as electric power, Internet bandwidth, and pulp and paper. In each case, Enron focused on the business sliver of intermediation...."

MQ, 2001, No. 1

LOOSE-TIGHT CULTURE

"Provide 'elbow room' to allow executives room to maneuver; 'head room' to allow them to make decisions without seeking constant approval from above; a clear link between daily activities and business results (even if not a P&L); ...something new to work on as often as possible."

MQ, 1998, No. 3

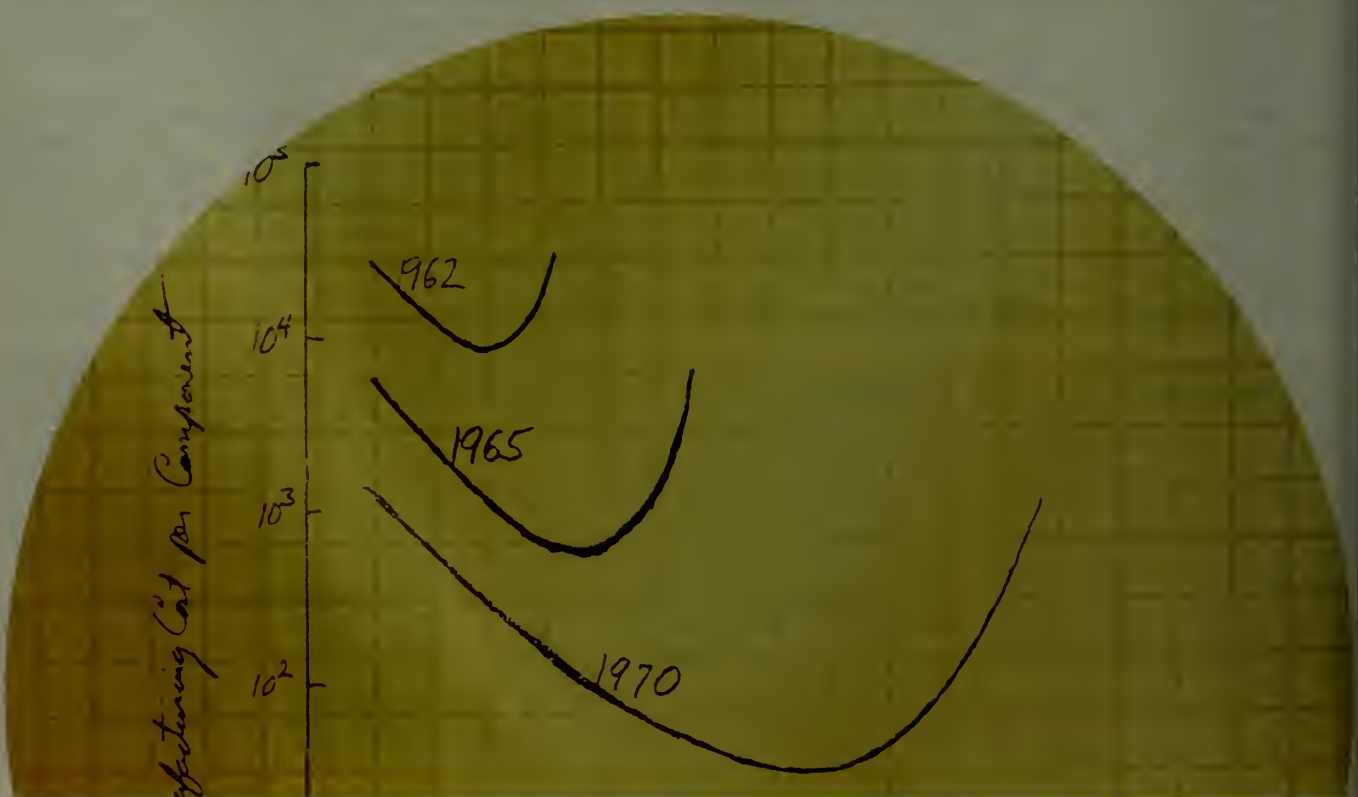
Will Moore's Law stand forever?

In 1965, Intel's Gordon Moore created a "law" that became shorthand for the rapid, unprecedented growth of technology. He predicted that the number of transistors on a chip would grow exponentially with each passing year.

At the time, even Gordon never imagined it might still be true today.

But Intel has developed new technologies that will allow us to squeeze one billion transistors on a chip (a far cry from the 2,300 on our first processor).

Gordon Moore sketched out the amazing pace of silicon technology development in 1965. His "law" remains valid today.





This wafer represents Moore's Law at work. The Intel® Itanium® 2 processors here hold over 220 million transistors each.

**This isn't science for science's sake.
It's science for your
company's sake. Because as we work
to fulfill Moore's Law, year
after year, companies everywhere can
do more at lower cost.
And that's not just a good law.
It's very good business.**



Sophisticated tools perform tests to ensure the highest-quality processor.



Processor production, constantly monitored by smart machines and smart people.



intel®

“I never said anything about fraud, accounting or any of those issues”

— Lowell Bryan, McKinsey senior partner

portant clients were also going off the rails. At Kmart, McKinsey produced work supporting the retailer's decision to sell more groceries in a bid to get shoppers to visit stores. It also was instrumental in creating Blue-Light.com, which was intended to be spun off in an initial public offering but never made it to market.

Cover Story

McKinsey began consulting for the retailer in 1994. In the ensuing years, Kmart's competitive position steadily eroded. “That is a long enough time for a firm to know if its advice has impact,” says an ex-McKinsey consultant. “But senior partners need to show revenue growth, so they are willing to continue to work with clients even if they feel there is no light at the end of the tunnel.” McKinsey ended its relationship in 2000 after disagreeing with new CEO Charles Conaway, who pursued a disastrous price war against Wal-Mart. Still, McKinsey's involvement through the mid- to late 1990s, when Kmart swiftly and steadily lost ground

the game were changing, and many McKinseyites saw former MBA classmates emerge overnight as multimillion-dollar entrepreneurial celebrities. Inside the firm, Gupta faced with all kinds of new pressures: whether McKinsey should start a venture-capital fund, or go public itself, start its own dot-com ventures as offshoots of the firm's consulting business; whether to accept equity instead of cash for an assignment with a startup. The partnership declined to take shares, as Goldman Sachs had done, but in other important ways it veered from the course it had long followed.

One of the most noticeable changes was a drift away from its longstanding policy of not linking its fees to client performance. Bower believed alternative fee arrangements would tempt consultants to focus on the wrong things. During the past 18 months, McKinsey has been structuring dozens of deals with blue-chip companies that call for the payment of an assignment-ending bonus if a client is satisfied with the results. In the past three years, it also began accepting payment in stock from approximately 150 upstart companies, though McKinsey points out that this is a small percentage of its 12

engagements in that time. Gupta says the change lowered the firm to serve smaller, innovative companies that didn't have the cash to pay McKinsey's standard fees of \$275,000 to \$350,000 a month. The e

ty was then sunk by a blind trust and liquidated as soon as possible into a profit for its partners. In other case, that

Spain's Telefónica, it added a clause in its contract giving it a cash kicker based on rising stock price of an Internet offshoot. McKinsey was advising. The firm collected a \$6.8 million bonus.

Yet even these concessions to the bonafide mentality during the boom height didn't prevent de

McKINSEY'S BLUE-CHIP CLIENT ROSTER

For decades, McKinsey has counseled some of the world's most successful companies. The lion's share of work, up to 40%, centers on strategy. But consulting on operations, organizational issues, and marketing also are big chunks—between 10% and 20%.

HEWLETT-PACKARD

A key adviser to CEO Carly Fiorina on HP's recent acquisition of Compaq

JOHNSON & JOHNSON

A longtime, highly successful client that has used McKinsey on dozens of engagements over 30 years

GENERAL MOTORS

Continues to assist the big automaker, which has shown gains over the competition in the past year



SIEMENS

Longtime counselor to vast German conglomerate on everything from sourcing parts from low-cost nations to factory consolidation

HOME DEPOT

Advised the big-box retailer on its expansion into Latin America



AEROFLOT

Assisted in the turnaround of Russia's biggest airline

Data: BusinessWeek

to Wal-Mart, did not serve either client or consultant well.

At Swissair Group, McKinsey advised a major shift in strategy that led the once highly regarded airline to spend nearly \$2 billion buying stakes in many small and troubled European airlines. The idea was for Swissair to expand into aviation services, providing everything from maintenance to food for other airlines as a way to increase revenues and profits. The strategy backfired, causing massive losses and a bankruptcy filing last October. McKinsey maintains it can't be held responsible for the outcome because it wasn't involved in the implementation of the strategy. At Global Crossing Ltd., McKinsey says its work was limited to only three projects, two of which involved information-technology outsourcing, so it cannot be blamed for the telecom provider's implosion.

The Internet boom posed an especially difficult challenge for McKinsey. The blanket assumption was that the rules of

tions. Many McKinsey consultants left for dot-com startups with names like Pet Quarters, Cyber Dialogue, Virtual Communities, and CarsDirect.com, many of which are now relegated to the junk heap of irrational exuberance. Across the firm, attrition rose only slightly during the boom, to over 20% a year in 1999 and 2000 from more typical levels of 18%. Some of the best people left, and some offices were hit hard by the exodus. In San Francisco, where McKinsey employs 150 professionals, a full third of the staff departed for other opportunities in 1999. “There was a whole group of people in the bubble who lost their way,” says Larry Mendonca, McKinsey partner who manages the San Francisco office. “They were trying to get their share of the bubble.”

McKinsey got its share, of course. In its quest for revenue growth, it pursued a whole new class of clientele. Demand for consulting soared from both startups and large corpora-



260-hp Acura TL Type-S. Who doesn't like to bring home a souvenir or two? The TL Type-S sports taut handling, leather-trimmed interior and an available Acura Satellite-Linked Navigation System.™ All of which are quite handy when crossing the land in search of your next must-have. Call 1-800-TO-Acura or visit acura.com.



“McKinsey was lucky. They dodged a bullet”

— Wayne E. Cooper, CEO of Kennedy Informa

clients, many of which had grown fearful that they were falling behind the Internet curve. During the peak two years of the dot-com boom, McKinsey alone did more than 1,000 e-commerce assignments, even as partners internally debated the true impact of the Net on clients. “I was in the room saying, ‘You’re smoking dope here on this dot-com stuff,’” recalls Roger Kline, a longtime McKinsey partner who oversees the financial-services practice.

But the firm even set up “accelerators,” or facilities, to help entrepreneurs launch new dot-coms with direct McKinsey help. “Maybe we should have been a little more circumspect than we were,” concedes Gupta. “But I don’t think we made any big errors or excesses.”

Not surprisingly, some of McKinsey’s dot-com clients fared little better than Pets.com Inc. EB2B Commerce Inc., which engaged McKinsey in early 2000 to help it develop a strategy after a merger, was recently warned by Nasdaq that its stock could be delisted. The company’s shares have plummeted to 15¢ from \$190 when McKinsey started working with it. Another high-tech client, Applied Digital Solutions Inc., which McKinsey helped in exchange for equity, is in the midst of a meltdown, with first-quarter losses of \$17 million. Applied Digital’s auditors resigned the account in May after an accounting dispute with the company, which describes itself as a developer of “life-enhancing personal safeguard technologies.” Shares of Applied Digital now trade for 57¢.

To be sure, McKinsey’s core blue-chip clients, which range from General Motors Corp. to Johnson & Johnson, remain the firm’s true bread and butter—partly because only those big companies can afford its fees. “McKinsey is expensive,” says Ralph Larsen, former CEO of J&J. “But what they provide is a fresh look at our thinking and a certain detachment. We use them carefully for selected projects, things of great significance, and they have been valuable to us.”

In managing the firm through the boom and the bust, Gupta now finds himself caught in a classic supply-demand squeeze, the sort of management dilemma for which a client would turn to McKinsey for advice: He hired too many people just as demand began to plummet. In an average year, McKinsey will offer consulting jobs to 3,100 MBAs and professionals in the expectation of getting roughly 2,000 accept-

McKINSEY’S RAJAT KUMAR GUPTA



ASSESSING THE GUPTA YEARS

BORN Dec. 2, 1948, in New Delhi

EDUCATION Bachelor of technology, mechanical engineering, Indian Institute of Technology, 1971; MBA, Harvard Business School, 1973.

FIRST JOB After a rejection by McKinsey & Co. due lack of work experience, a Harvard B-school professor intervened to help him get his job as an associate at the firm’s New York office in 1973.

CURRENT POSITION Managing partner, McKinsey, since 1994.

MOTIVATION “Business is a force for good. It’s a noble cause. To increase the performance of our clients helps create wealth and raises the standard of living around the world.”

WHERE HE EXCELLED...

- Led vast expansion into emerging markets, such as India, China, and South Korea.
- Doubled the number of leadership positions within the firm to 150, increasing partner involvement in governance.
- Resisted pressure to allow consultants to create their own startups during dot-com boom.

...AND WHERE HE DIDN'T

- Quest for growth may have compromised some of the firm’s values.
- Accepted more engagements from less-prestigious clients.
- Allowed firm to accept equity and cash bonuses for client work.

ances. In 2000, however, more than 2,700 people accepted offers to join the firm. They apparently knew what McKinsey didn’t yet get: The boom was over. By the following year, with the bubble clearly burst, the firm’s attrition rate fell to only 5%. Suddenly, just as demand for business started falling off, McKinsey had too many consultants on the payroll, fewer leaving for other opportunities. “We honored the offer and didn’t push people out,” says Gupta, “and we had professional layoffs other than our traditional up-or-out system.”

As McKinsey begins its months-long process early next year to elect a new managing partner, the firm will likely toast Gupta as the man who led the firm to new growth records in new markets around the world. “In every generation, there are issues that come up that define the firm,” he says. “We’ve had our share in the last decade. But I’m very proud of where we’ve come out.” The question for his successor is whether he expanded the firm at the expense of the culture and values that made McKinsey tower above its peers.

With Joann Muller in Detroit and Wendy Zellner in D

Cover Story

BusinessWeek online

For an interview with Rajat Gupta, go to the July 8th issue online
www.businessweek.com.

If You Own or Operate a Commercial, Residential or Public Building Constructed With Asbestos-Containing Products or Have Other Claims Against W. R. Grace

Your Claims Must Be Filed By March 31, 2003

W. R. Grace, its predecessors, subsidiaries, and other related entities ("Grace") have filed for protection under Chapter 11 of the U.S. Bankruptcy Code. The Bankruptcy Court has ordered that all individuals and entities with Asbestos Property Damage Claims or certain Other Claims against Grace must file these claims on or before March 31, 2003 ("Bar Date").

Who is Affected by this Notice?

Asbestos Property Damage Claimants

Individuals and entities that own or manage commercial, public and high-rise residential buildings that have asbestos-containing products may be affected including schools, hotels, government buildings, theaters, airports, churches, and other public facilities.

Asbestos Property Damage Claims include, among other claims, the cost of removal, the diminution of property value or economic loss, etc., caused by asbestos in products manufactured by Grace or from vermiculite mined, milled, processed, or sold by Grace.

Other Claimants

Other Claimants include individuals and entities with claims other than Asbestos Personal Injury Claims. These include general unsecured trade claims, contract claims, environmental claims, and Medical Monitoring Claims which allege no current personal injury, but significant exposure to Grace asbestos or vermiculite products requiring the claimant to be examined medically or tested to detect possible future injury.

What Types of Products are Involved?

Grace Asbestos-Containing Products

Grace produced and marketed vermiculite products containing added asbestos primarily to the commercial construction industry.

From 1959 to 1973, Grace marketed Mono-Kote 3 (MK-3), an asbestos-containing, wet, spray-applied fireproofing product used to provide fire protection for the enclosed steel structures of large buildings. Other Grace products included Zonolite Acoustical Plastic, and other acoustical plaster and texture products used primarily on interior ceilings and walls.

Grace Vermiculite Products

Grace mined, produced and marketed vermiculite products, some of which may have contained naturally occurring asbestos. The products were sold to the building construction, agricultural/horticultural and consumer markets. These products included Monokote Fireproofing, Zonolite Concrete Roof Decks and Zonolite Masonry Insulation.

How do I file a Claim?

To preserve your claim, you must file the appropriate Proof of Claim Form with the Claims Agent so that it is received by March 31, 2003. Failure to file a Proof of Claim Form by the Bar Date may result in your claim not being considered for payment.

This is a Summary Notice only. For complete information including the Claims Bar Date Notice, Proof of Claim Forms, instructions for filing a claim, a list of Grace asbestos-containing products, and a list of Grace entities write to: Claims Agent, Re: W. R. Grace & Co. Bankruptcy, P. O. Box 1620, Faribault, MN 55021-1620, or call:

1-800-432-1909 or visit www.graceclaims.com

PARTING THE VEIL AT HEARST

New boss Victor Ganzi reveals how the sprawling giant aims to sprawl wider still

BY TOM LOWRY

It was a gala on a grand scale, even for New York. On the Friday night before Memorial Day, 500 guests streamed into a white tent at Lincoln Center to honor Frank A. Bennack Jr., retiring after nearly 24 years as CEO of Hearst Corp. Mingling among the glitterati were Bennack's successor, Victor F. Ganzi; legendary *Cosmopolitan* editor Helen Gurley Brown; and the most famous of all William Randolph Hearst's progeny, a bejeweled Patricia Hearst, accompanied by her husband, Bernard Shaw, Hearst's security chief. The New York Philharmonic played, as did country duo Brooks & Dunn, favorites of San Antonio native Bennack. Applause was warm when execs announced a \$1 million chair in Bennack's name at the journalism school at the University of Texas. Bennack's other gifts included a Frederic Remington sculpture and a 1940s woody station wagon for his 1,500-acre Texas ranch, Eagle Bluff.

Most remarkable, though, was the total blackout of the bash in the New York press. No mention in the Styles section of *The New York Times*. No gossip in the tabloids. Nothing. It was vintage Hearst, a private company whose

growth has exploded but that remains largely under the radar. That no word of the party leaked out speaks volumes about how 69-year-old Bennack has protected and managed the closely held media empire that William Randolph Hearst (WRH) founded 115 years ago. "It doesn't surprise me the party didn't get any ink. That's just how Frank wanted it," says Phil Bronstein, executive editor of Hearst's *San Francisco Chronicle*, who flew in for the event.

Bennack's retirement would be noteworthy if only for his longevity as CEO in the fickle media world. But he is also the man who built up and transformed the company over the past two decades. "Before Frank took over, Hearst had a reputation as a sleepy publishing company," says Steven Rattner, a managing director of Quadrangle Group, a media and communications investment firm. "Today, he has assembled a tremendous group of media assets."

Indeed, intolerant of debt and with a knack for striking savvy partnerships, Bennack has gone multimedia—with newspapers, magazines, TV stations, cable channels, Internet businesses, and real estate (table). The company generates an estimated \$5.2 billion a year in revenues—a 600% increase since 1979, when

Bennack became CEO. Estimated net income topped \$500 million last year. Nearly 80% of Hearst's more than 100 businesses were created or purchased under Bennack, everything from the *Houston Chronicle* to stakes in the ESPN and Lifetime cable networks. When he became CEO, Hearst hadn't bought a newspaper in a new city in 50 years. "He has quietly and smartly created a great company, all the while with eyes in check," says Robert A. Iger, president of Walt Disney Co., which is a cable partner with Hearst.

Incoming CEO Ganzi inherits a stellar portfolio of assets, but he arrives at a critical time. Hearst derives 60% of its revenue from ads—and the worst advertising recession in decades still lingers. The likelihood of further media deregulation, too, has players scrambling to reevaluate how big they need to be. Can Ganzi, 55, a former tax lawyer who was Bennack's deputy for 12 years, guide Hearst through this tough terrain? He will be just the fifth Hearst CEO since WRH died in 1951 at 88.

At the same time, Ganzi faces the task of keeping the

THE HEARST EMPIRE

The privately held company built by William Randolph Hearst (right) has gone way beyond its newspaper roots.

In his will, Hearst set up a trust to oversee the company. The board of trustees has 13 seats; five of which are reserved for family members. Hearst Corp. also has a board of 20 directors, of whom seven are family members.

Estimated revenues: \$5.2 billion.

Estimated net income: \$500 million.

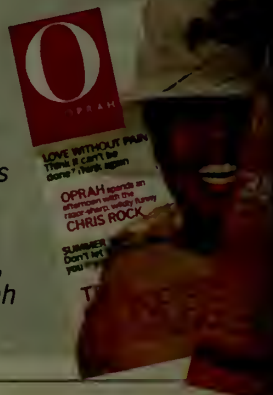
Holdings (at far right) include:



BROADCASTING Holds 66% of the publicly traded Hearst-Argyle Corp., which has 27 television stations, reaching 17.5% of households in the country.

MAGAZINES

Publishes 16, including *Good Housekeeping*, *Cosmopolitan*, *Esquire*, *Harper's Bazaar*, *SmartMoney* (together with *Ow Jones*), and *O, The Oprah Magazine*.



VICTOR F. GANZI

TITLE Chief Executive Officer and President, Hearst Corp.

BORN Queens, N. Y., 1947

EDUCATION Fordham, Harvard Law

EARLIER CAREER Tax lawyer at firm Roger & Wells, 1973-1990. Hearst was a big client.

FAMILY Wife, Pat, and 24-year-old twin daughters. Ganzi's father was a typesetter in the 1930s at the *New York Mirror*, a Hearst paper.

FAVORITE RESTAURANT

The Palm: His family has owned a 50% stake in the restaurant chain for 75 years.

ever-growing Hearst family happy. WRH's five sons have spawned a brood of 61 direct descendants, scattered across the world and all with varying interests. And Ganzi will eventually need to appoint a No.2, a choice that is stirring much speculation. In a gesture to a new era at Hearst, plans are under way to construct a 42-floor glass-and-steel tower atop Hearst's six-story Midtown Man-

hattan art deco headquarters. The tower will allow Hearst to consolidate its businesses, now scattered at five New York locations, but at a hefty price, possibly \$500 million or more.

In a rare interview in late June in a dark-paneled library at Hearst's offices, Ganzi and Bennack, who remains vice-chairman of the board, pulled back the veil on their storied company. Both executives say they know Hearst will have to get bigger and will do so, initially at least, by buying more TV stations and expanding its magazine group. The executives did not rule out getting back into the cable-operating business, which Hearst left in the late 1980s when it sold a small Bay area cable system to John C. Malone. "We want to make bets that are reasonable, instead of betting the ranch on any given project," says Ganzi.

He's already showing he can ante up. In several weeks, Hearst is expected to announce the launch of *Lifetime* magazine, a bimonthly targeted at women, an extension of the top-rated cable network, of which Hearst owns 50%. On May 31, Hearst snapped up interior design magazine *Veranda*, an Atlanta bimonthly, for an estimated \$50 million. And back in April, Hearst's smashing two-year-old partnership with Oprah Winfrey, *O, The Oprah Magazine*, introduced its first overseas edition, in South Africa.

Now that regulators are expected to loosen rules on how many TV stations a company may own, Hearst, through its 66% stake in public company Hearst-Argyle Television Inc., has begun scouting for acquisitions, especially in the 12 cities where it publishes its dailies. Hearst made an unusual foray into public markets back in 1997 by merging its TV stations with Argyle. "The only way to grow was with the public currency," explains Bennack. A year later, it would

ENTERTAINMENT

Has a 20% stake in ESPN, a 37.5% stake in A&E, and 50% of Lifetime cable networks. Also owns King Features Syndicate.



INTERACTIVE

Owns drugstore.com, genealogy.com, and a 30% stake in iVillage.com.

BUSINESS MEDIA

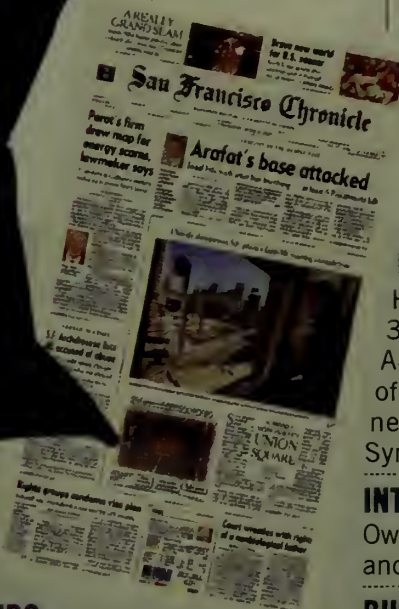
Owns 20 business-to-business services and databases, including inventory service Stocknet.

Data: BusinessWeek

CAN GANZI
PUSH WRH'S
LEGACY
FORWARD?

NEWSPAPERS

Owns 12 dailies, including the *Houston Chronicle*, *San Francisco Chronicle*, *Seattle Post-Intelligencer*, and *Midland (Tex.) Reporter-Telegram*.



buy the TV and radio station holdings of Pulitzer Inc. for \$1.7 billion, expanding its number of stations by 40%, to 24. "We joked with the Pulitzer executives that all was forgiven from the days of the Hearst-Pulitzer newspaper wars in New York," says Bennack, who became publisher of Hearst's *San Antonio Light* at 34. Even though Hearst-Argyle, which now has 27 stations, was hard-hit by the ad recession last year—revenues fell 14%, to \$642 million—Wall Street is still bullish about the company's prospects.

Hearst may be known best for newspapers and magazines. But today about 40% of aftertax cash flow comes from its entertainment and syndication business, mostly its cable channels. In 1981, Bennack made a shrewd move: launching the precursors to today's Lifetime and A&E Networks, both in partnership with ABC. The channels lost \$50



A NEW ERA:
Proposed Hearst HQ to be completed in 2006

deals, Hearst—whose name was once synonymous with Big Media—is small compared with today's giants. Its \$5 billion in annual revenues is slightly higher than those of just the music unit of \$38 billion AOL Time Warner Inc. Would Ganzi ever do a whopper deal to give Hearst that kind of heft? Ganzi says he sees no need to do so currently but adds that nothing in WRH's

will prohibits the sale of the company. "We debate this issue a lot: Do you have to get bigger or get out?" says Austin Hearst, a Hearst executive, board member, and WRH's grandson. "The answer is probably yes, but, remember, the dinosaurs were around for 200 million years."

A Stone Age fossil, certainly not, but Hearst has a reputation for sometimes

newspaper, and TV-station business says Quadrangle's Rattner. "Be every day we have seen that the of scale are overblown." And most media companies, which are p Hearst's private ownership status it flexibility. Says Cathleen P. Blac president of Hearst Magazines Div. can look at businesses that public panies can't because they'd just get beat up on Wall Street."

Perhaps Hearst's most idiosyncrasy feature is its structure. The corporation is owned by the Hearst Family, overseen by a 13-member board of trustees. In his will, WRH stipulated only five family members should as trustees, who are appointed for Bennack and Ganzi are both trustees. Hearst Corp. has its own board, seeing the day-to-day operations of units. Seven family members now on the 20-person corporate board. The trust will expire with the death of last family member born before 1913. At that time, Hearst heirs will own company's shares outright.

The boards meet quarterly and more frequently, depending on deal business decisions. Family members 18, who reap the profits, get financial information on a quarterly basis, and

Does Ganzi need to do a whopper deal to give Hearst big-time heft? "We debate this issue a lot," says executive Austin Hearst. "Do you have to get bigger or get out?"

million between them in the first years but now are some of the hottest properties on TV. Hearst's 50% stake in No. 1-rated Lifetime is estimated at more than \$2.5 billion, and its 37.5% stake in the A&E is valued at more than \$1.8 billion, according to consultancy Kagan World Media.

Bennack's best bet in cable turned out to be his 1990 purchase of RJR Nabisco's 20% stake in ESPN—at the time still a fledgling cable sports channel. Bennack paid about \$160 million for the stake. Today, it's worth an estimated \$4 billion. "Frank Bennack made a lot of Hearsts even wealthier. Think about that," says Disney board member Thomas S. Murphy, the retired chairman of then-Capital Cities/ABC Inc. (ABC owns 80% of ESPN.) Hearst still has the cable bug: On July 1, it plans to launch Cosmopolitan channel, tied to the popular women's magazine, in Latin America, with 5 million households signed on. The U.S. could be next.

Still, for all its dynamic launches and

being too plodding. "Let's put it this way," says one publishing executive. "Hearst is the U.S. Post Office, and [Newhouse family-owned magazine publisher] Condé Nast is FedEx. Hearst licks that stamp, and sooner or later it'll get there." On the other hand, Condé Nast is far less profitable. Another executive says Hearst has missed opportunities by being overly conservative. "It tests a product, tests it again, and then tests one more time," he says. "Then it decides it's a business it should not go into."

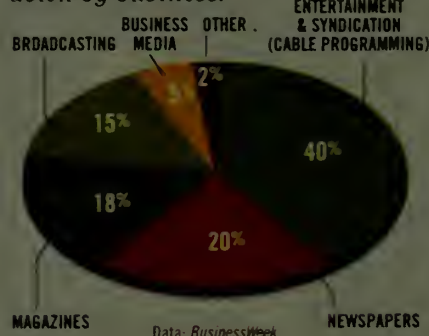
Some dismiss the criticisms, particularly those about size. "Hearst is definitely a scale player in the magazine,

nack and Ganzi say they stay in touch regularly to answer any questions. The oldest living heir, WRH's grandson George Randolph Hearst Jr., 74, is the chairman. Only six family members are in Hearst businesses. They include George's son, George III, 46, associated publisher of the *New York Times* (N.Y.) *Union*; his brother Stephen, 45, who oversees Hearst real estate operations from California and one of Paul's sisters, Anne Randolph Hearst, 44, contributor to *Time* & *Country*.

The Hearst family is as accountable as the heirs as an executive of a public company is to shareholders. Bennack knows

HOW THE CASH FLOWS AT HEARST

Estimated annual aftertax cash flow is \$700 million. This is how it breaks down by business:



family member, spouse, kid, and of lore. "We spend the time we be talking to analysts talking to nily," says the press-shy Ben-Even for a private company, has been extraordinarily guarded releasing financial information. "I even get a courtesy return phone says Ed Atorino, an analyst at k & Partners who covers Hearst's competitors.

gs haven't always been *simpatico* l the heirs. Following the spinout TV stations, three grandchildren o court in 1998 to determine if ould be disinherited if they filed a complaining about certain proce- at the company. William Randolph II and his sisters Deborah Hearst and Joanne Hearst Castro com- they weren't given enough ac- financial records or enough say in i-making. A judge ruled they could only certain kinds of complaints at being disinherited. The three sued. Their lawyer, John A. Stur- declined to comment but did say subsequently increased its pay- to heirs. A Hearst spokeswoman dividends have been raised for Says William "Will" Randolph III, 53, a board member and r at venture-capital firm Kleiner

Debate this t out?"

as Caufield & Byers: very public complaints vexing for Frank. It im. This was squeaky-activity from one part family."

more troubling chap- Bennack's career Hearst's purchase of n Francisco Chron- its rival, the San isco Examiner, en the company's p. But Hearst want- er to sell or shutter aminer and buy the Chronicle instead. By it had a deal, but an st suit led to a trial nbarassing revelations Examiner publisher hy White
sed San **BLACK:** A isco May- contender Willie L. for the Jr. favor- No. 2 spot?

able coverage if he supported the *Chron- icle's* sale to Hearst. The company ended up having to subsidize local publishers to the tune of \$66 million over three years to run the *Examiner*, effectively raising the *Chronicle's* price to \$726 million.

One high-profile project Bennack re- fused to prop up: *Talk*, the celebrity mag- azine edited by Tina Brown. Hearst's de- cision to pull out of its 50-50 *Talk* partnership with Disney's Miramax Films Inc. unit led to the title's demise in Jan- uary after 2½ years of losses, estimated to be about \$20 million for Hearst. "Not everything works," says Bennack. "I have great respect for Tina and our partners at Miramax, and we don't like stopping publications—but there were no cost ben- efits to continue." Bennack blames *Talk's* troubles on a combination of factors, in- cluding the advertising recession that got worse after September 11.

Another money-loser for Hearst has been the Internet, although the company wasn't nearly as zealous about cyberspace as some of its media brethren. Bennack says Hearst's Internet investments are still running a

loss, but it did make several good bets, buying big stakes in Netscape Communications, broad- cast.com, and Exodus Com- munications, and selling before the Net bubble

burst. Ganzi says the Internet will still be an "essential piece of our business."

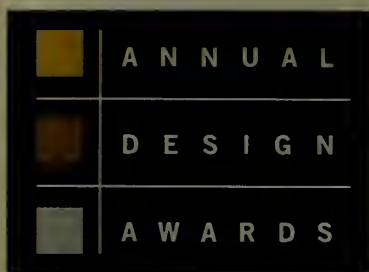
Who helps Ganzi with those business- es—with his choice for deputy still un- decided? Names emerging so far include magazine division chief Black, who is a former publisher of Gannett's *USA To- day*, and newspaper division exec Steven Swartz, 40, ex-editor/CEO of *SmartMoney* magazine. Ganzi says he's in no rush, noting that Bennack was in his CEO job for six years before he appointed a chief operating officer. "For people that have a chip down on this, they are going to have lots of time to chat in the hall- ways," says Black.

So what would legendary William Randolph Hearst think of his company today? It was always WRH's goal to be more than just a newspaper company, and Bennack "followed in that direction by believing information should be con- veyed in a variety of formats," says David Nasaw, a historian and author of the biography *The Chief: The Life of William Randolph Hearst*, published in 2000. "The Chief created a media com- pany like a wheel, where the center was

print and spokes branched off in a variety of directions and formats. Frank didn't be- tray that direction a bit." Now it falls to Victor Ganzi to navigate be- tween the demands of the past and the pull of the future. ■

BENNAK:
Remains
vice-
chair-
man





THE BEST PRODUCTS OF THE YEAR

W

 GOLD



**FORD
THUNDERBIRD**

Designers:
Ford Motor
The two-seat
roadster is a

*modern rendition
of the 1950s
original classic. It
has a removable
top with porthole
windows. \$35,495*



Every business cycle weeds out the old, breaks down the established order, and opens the way for innovation. The Industrial Design Excellence Awards (IDEA) for 2002 shows that this most recent cycle is no different. Given by the Industrial Designers Society of America and sponsored by *BusinessWeek*, the IDEA winners this year reflect major changes on the design scene. The results? A surprising number of Asian companies are emerging as design innovators. The hierarchy of the design industry

is being shaken as smaller firms muscle their way into the top tier. Perhaps of most significance, the aesthetic sensibility of American culture is shifting.

Many of the award-winning products this year appear to be reflecting a more sober, post-September 11, security-conscious society. The rounded, biomorphic, soft shapes and translucent plastic see-through openness that defined so many products in the 1990s are gone. What's in is a new modernism of sharp edges, ti

WINNERS

2002

ners, and straight lines. Colors are darker, packaging more opaque. If '90s product design reflected a female organic sensibility, today's is distinctly harder, edgier, more military, more male. Awards went to the black, angular IBM Net Vista flat-panel PC that is suspended in the air by an articulated arm; black and white body armor for Lacrosse (page 92); and a mouse that is metallic and all edges (page 89). The tougher sensibility is evident even in boat styling. One winner is a jet-powered, aluminum-hulled catamaran. Resembling a Marine Corps landing craft, it's the Hummer of pleasure boats (page 86). The military itself is paying more attention to design. The award-winning, battle-hardened Command Console (page 89) is a great example.

Just as people flock to movies in stressful times, they also appear hungry for consumer products to make their lives not only easier but also more

fun. An exceptional number of consumer products won awards in 2002. Some, like the jazzy

Ford Thunderbird, harken back to golden years. Others—such as the BMW-designed Streetcarver skateboard and the Bearhug snowshoe binding by Helix Design—reinvent familiar products for the better. This is also true of Dil-

SILVER

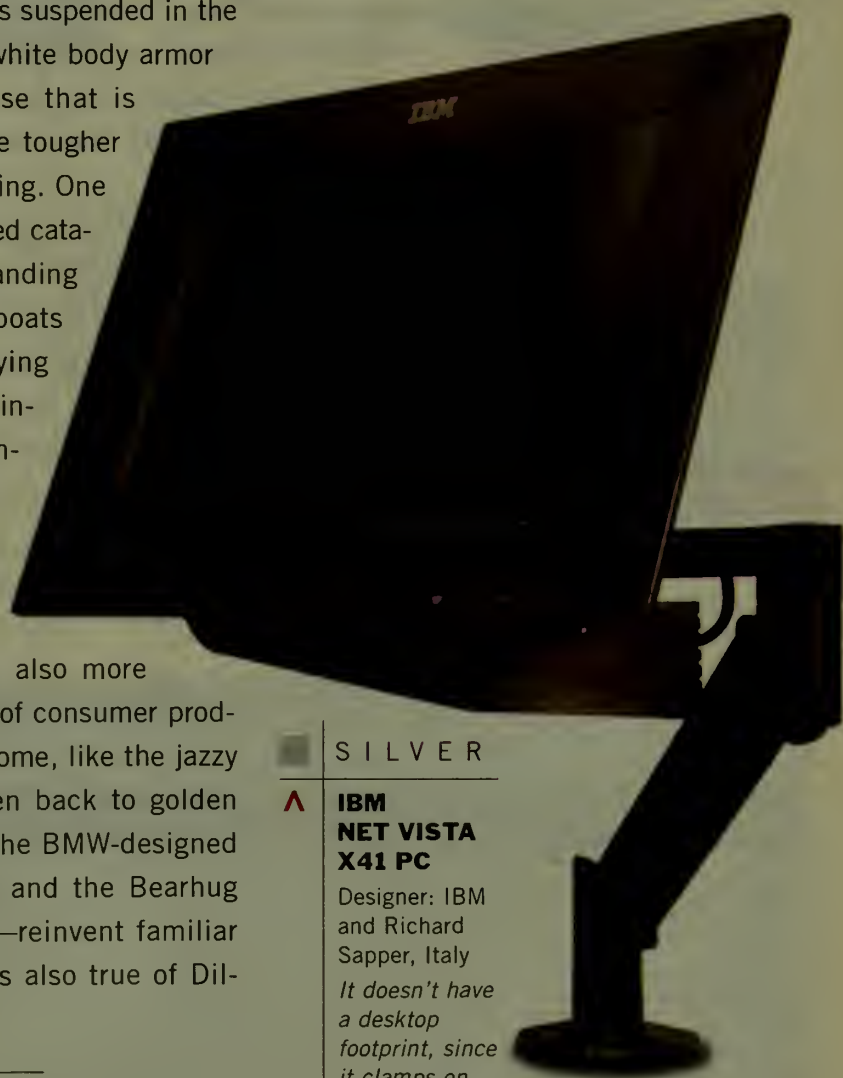
STREETCARVER

Designer: BMW
New steering, suspension, and axle designs let this skateboard ride like a surfboard or snowboard.
\$499

SILVER

IBM NET VISTA X41 PC

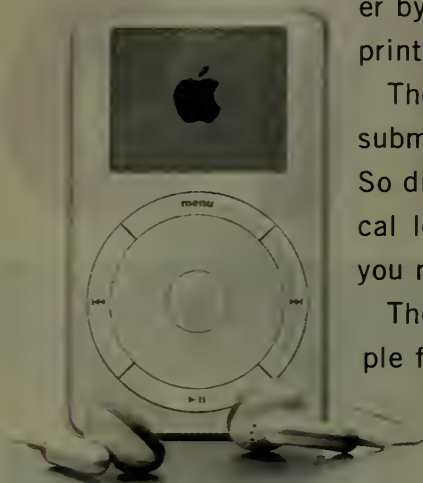
Designer: IBM and Richard Sapper, Italy
It doesn't have a desktop footprint, since it clamps on. Controls and DVD player descend from a hidden bay.
\$1,499



ANNUAL

DESIGN

AWARDS



GOLD

A IPOD MP3 MUSIC PLAYER

Designer:
Apple Computer
*A scroll wheel
lets people get
to songs fast.*
\$399

BusinessWeek online

For a complete list of all the winning products and designers, go to the July 8th issue online at www.businessweek.com.

bert's Ultimate Cubicle, Palo Alto (Calif.)-based IDEO's playful thinking about how to make office cubicles more livable.

Awards went to super-high-tech consumer products as well. Apple Computer's iPod MP3 music player is the first to hold 1,000 songs, have 5 gigabytes of data, and weigh 6.5 ounces. Hewlett-Packard, with help from New York City-based Smart Design, made digital photography easier by junking the PC. Its award-winning Photosmart 100 printer works directly with digital cameras.

Then there's the Spyfish, a miniature remote-controlled submarine for exploring reefs that won an IDEA (page 92). So did the Segway Human Transporter (page 86). A radical low-tech breakthrough is the OXO measuring cup—you measure by looking into it.

There were lots of surprises this year. Samsung tied Apple for most prizes won (five). The South Korean company is becoming a design powerhouse on the world scene (page 88). IDEO continued to dominate the industry, but Smart Design came on strong.

Boston-based Design Continuum snagged the first Catalyst Award for the greatest bottom-line impact of an IDEA winner (page 94).

A surprising number of architects won awards. Rem Koolhaas teamed up with IDEO to win two for Prada, while David Rockwell won two for his hotels.

In 2002, there were 1,265 entries from around the world, including many from Korea, Japan, Malaysia, Turkey, Germany, Switzerland, Hong Kong, Britain, France, the Netherlands, Taiwan, Denmark, Ireland, Northern Ireland, and Canada. The 174 winners took in 41 golds, 60 silvers, and 73 bronzes.

Check out the following pages for more great designs.

By Bruce Nussbaum in New York

GOLD

A DILBERT ULTIMATE CUBICLE

Design:
and Un
Media
*Dilbert
love the
cubicle
a drop-
desk, c
punch
and eve
of light
simulat
moving
the sky.*

WINNERS FOR 2002...

Here are many of the winners of the Industrial Design Excellence Awards:

DESIGN FIRMS	AWARDS			
	GOLD	SILVER	BRONZE	TOTAL
IDEO	3	7	4	14
SMART DESIGN	2	4	1	7
DESIGN CONTINUUM	1	3	2	6
ALTITUDE	3		1	4
ECCO DESIGN		3		3
INSIGHT PRODUCT DEV.	1		2	3
LUNAR DESIGN	1	2		3
@RADICAL.MEDIA			2	2
BIG DESIGN		1	1	2

CORPORATIONS	AWARDS				AWARDS	
	GOLD	SILVER	BRONZE	TOTAL	GOLD	SILVER BR
APPLE COMPUTER	4	1		5		
SAMSUNG	1	3	1	5		
STEELCASE	1	3		4		
IBM		3		3		
OXO INT'L.	2	1		3		
A.T. CROSS PEN		1	1	2		
BATELLE HEALTH CARE PRODUCTS			2	2		
BELKIN COMPONENTS	1	1		2		
BENQ CORP.			2	2		
BOZART			1	1		
DELL COMPUTER				1		
FISHER-PRICE						
H2EYE INT'L LTD.	1			1		
HANDSPRING	1			1		
HERMAN MILLER				2		
MICROSOFT						
NISSAN				2		
PRADA				1		

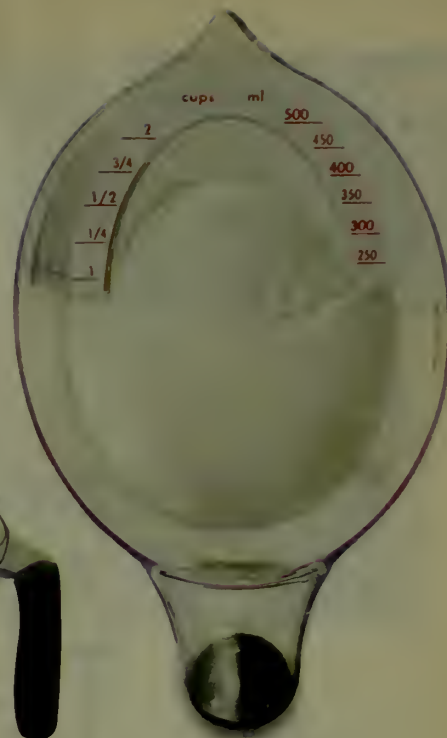


SILVER

> OXO MEASURING CUPS

Designers: Smart Design and Bang Zoom Design

Forget bending down or lifting a cup to measure the sugar. Just peer into it. \$5.99



BRONZE

V BEARHUG BINDING

Designer: Helix Design

Once this binding is fitted to the boot, it's easy to step in and out. \$249.50, with Tubbs snowshoes



BRONZE

< HEWLETT-PACKARD PHOTOSMART 100 PRINTER

Designer: Smart Design
Eliminating the computer, it prints

4x6 photos directly from digital cameras. It accepts CompactFlash, Memory Stick, and SmartMedia cards. \$179.99



...AND OVER FIVE YEARS

Year after year, some design firms and corporations win:

FIRMS	AWARDS		
	1998-2001	2002	TOTAL
OXO	34	14	48
SMART DESIGN	21	1	22
BANG ZOOM DESIGN	15	0	15
HELMUT LANG	15	0	15
LAZAR BELL	14	0	14
STUDIO SLASH	11	3	14
STUDIO SLASH	7	7	14
CONTINUUM	6	6	12
	7	4	11
	10	1	11
	10	1	11

CORPORATIONS	AWARDS		
	1998-2001	2002	TOTAL
APPLE	12	5	17
SAMSUNG	12	5	17
IBM	11	3	14
MICROSOFT	9	2	11
FISHER-PRICE	8	2	10
HEWLETT-PACKARD	9	1	10
STEELCASE	6	4	10
BLACK & DECKER	8	1	9
COMPAQ	8	1	9
NIKE	8	1	9

	AWARDS		
	1998-2001	2002	TOTAL
OXO INTERNATIONAL	6	3	9
PHILIPS DESIGN	9	0	9
MOTOROLA	7	1	8
HERMAN MILLER	5	2	7
SYMBOL TECHNOLOGIES	7	0	7
STANLEY WORKS	6	1	7

Data: Industrial Designers Society of America

ANNUAL

DESIGN

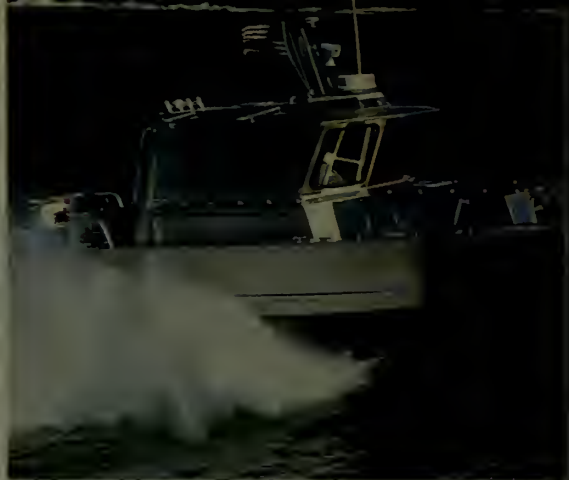
AWARDS

SILVER

> **J3200 CATAMARAN**

Designer:
Moose Boats

A fast,
shallow-draft,
rugged boat.
\$394,000



Zippy Transport For City and Surf

TRANSPORTATION

There are all kinds of ways to travel. The Segway Human Transporter, designed by Dean Kamen, is one of the most hyped prototype products of our era. The device combines breakthroughs in self-balancing gyroscopes and electronics to create a battery-powered urban person-mover. Lean forward, and it moves forward. Lean back, and it brakes. The interface on its LCD screen is a friendly human face. The battery packs are recyclable. The 80-lb. Segway will be on sale in late 2002.

Already available in the market for much less is the electric-powered

Xootr Scooter. Lunar Design came up with a 19.8-lb personal-transportation vehicle with a low, slim deck that houses the batteries and a small,

rear-mounted motor. Aimed at the same urban/suburban commuting population as the Segway, the Xootr folds easily and can stow under bus or train seats. Recharges in 75 minutes. It can accelerate from 0 mph to 12 mph in 5 seconds. Wow!

The J3200 Catamaran is a complete redesign of 30-foot pleasure boats. It's a fast yet stable and tough-looking boat that doesn't use traditional materials. This is the first time aluminum has been used in this class of boat. Turbo-diesel engines drive water jets. No propellers.

GOLD

V **SEGWAY HUMAN TRANSPORTER (HT)**

Designer:
Segway LLC

It's the anti-car,
promising personal
mobility with
less pollution.
\$3,000

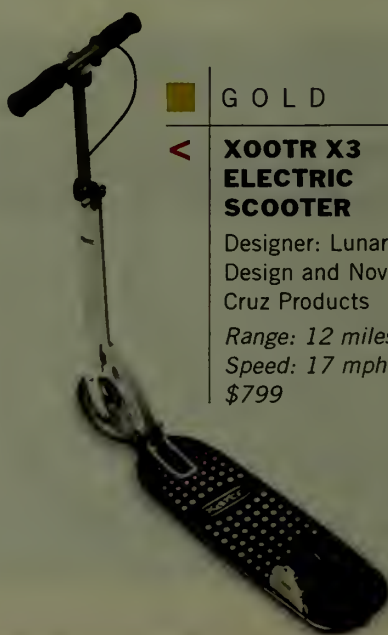


GOLD

< **XOOTR X3 ELECTRIC SCOOTER**

Designer: Lunar
Design and Nova
Cruz Products

Range: 12 miles.
Speed: 17 mph.
\$799



Scenes from the Great Indoors

INTERIORS

Rockwell Group transformed a building put up in 1911 into an elegant W Hotel for the Starwood hotel chain. The Guardian Life Building in New York reflected the French architectural style of the late 19th century when it was constructed, and Rockwell built on these features.

IDEO researched the habits of Prada shoppers and found they spent hours with their personal store staffers. The dressing room maximizes the time spent together. An interactive closet reads RF (radio frequency) tags on clothes, providing information on a nearby flat touch screen on size and color availability and possible accessories. The room's transparent glass doors can be made opaque for privacy. This store breaks the mold.

Apple Computer had to build stores fast when it decided to roll out 27 of them recently. With Eight Inc.'s help, Apple succeeded in communicating its unique product-design language in large commercial spaces. The Apple stores project a digital lifestyle, not a buy-the-box atmosphere. Clean lines, wood, and glass all project a cool Apple image.



SILVER

▲ PRADA DRESSING ROOM

Designers: IDEO, UK; OMA/AMO, the Netherlands; KPT; Prada, Italy

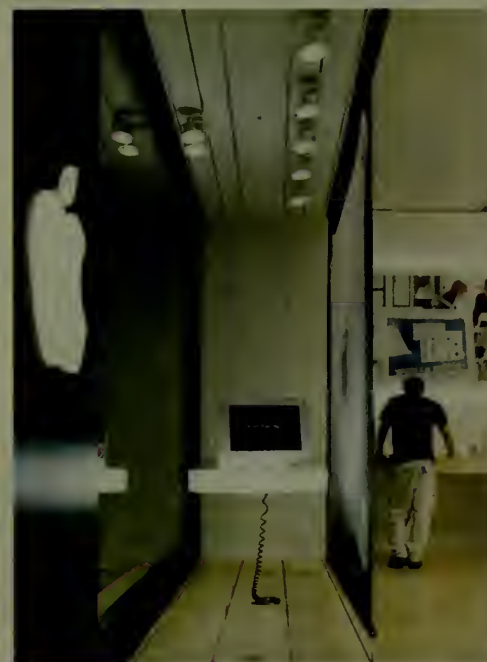
A "magic mirror" displays a back view of the customer trying on clothes.

GOLD

▼ APPLE COMPUTER RETAIL STORES

Designers: Eight Inc; Gensler; Apple Computer

Each store has a Genius Bar where resident gurus answer computer and software questions.



SILVER

▼ W UNION SQUARE HOTEL

Designer: Rockwell Group

A grand staircase runs from the lobby to a restored ballroom that overlooks a park.



(CLOCKWISE FROM LEFT) PHOTOGRAPHS BY PAUL WARHOL/ROCKWELL GROUP; MICHAEL MORAN; SHERMAN TAKATA



A N N U A L



D E S I G N



A W A R D S

Samsung Shows Off

S A M S U N G

These five winners for 2002 and a total of 17 since 1998 have made Samsung a global power in product design. Samsung's 15- and 17-inch LCD

flat-panel TV monitor has a detachable stand and can be mounted on a wall or hung from a ceiling. The speakers can be detached, and the controls are hidden away.

The Family Doctor is Samsung's vision of a home health diagnostic kit. A person would swallow a small high-tech pill that examines internal organs. The rest of the device monitors the results, feeding data back to a physician.

Samsung deliberately appealed to the fashion sense of trendy, young, upscale females in designing its thin DVD player. The DVD-L100 portable player has an elegant simplicity and is less than an inch thick.

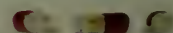
Another futuristic concept is the Smart Cooker. A cooking pad is stored inside the unit and unrolled when needed. A touch screen connects to the Net, allowing recipes and cooking times to be downloaded.

G O L D

< THE FAMILY DOCTOR

Designer:
Samsung

Samsung's vision of home diagnostics is based on swallowing a "smart" pill and relaying data to the doctor.



S I L V E R

^ 15"/17" TFT SYNCMASTER LCD TV MONITOR

Designers: Samsung U.K. and Korea
The LCD monitor is HDTV-compatible and can be mounted on a wall. \$5,000.

S I L

< PORTABLE DVD PLAYER

Designer: Samsung
It looks like a small purse, a mini-theater.

B R O N Z E

> SMART COOKER

Designer:
Samsung

A sensor would measure cholesterol, fat, and taste, allowing the chef to adjust the recipe for the healthiest mix.

Data On the Fly

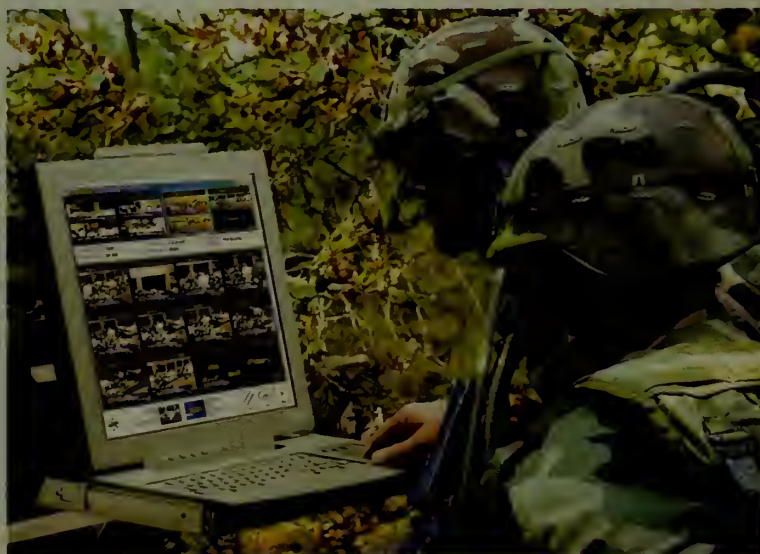
COMPUTERS

The Command Console computer is designed to operate in the new digital combat zone. It can be deployed quickly, is ultraslim and light, and has a liquid-crystal-display touch screen and a backlit keyboard, good for use with night-vision goggles. It employs off-the-shelf commercial electronic components, making it easy to get spare parts almost anywhere in the world.

Logitech International's MouseMan Traveler is designed for businesspeople on the road, folks with small offices, or those who use notebook computers. The MouseMan has hard edges and an aluminum covering.

"The TREO does it all—it's a cell phone, PDA, and Web browser with e-mail and SMS messaging," says IDEA juror, Jack Beduhn. It also can come with a full QWERTY keyboard. The iMac pioneered the big shift in computers, moving the focus away from the box to the screen itself.

The 15-inch LCD flat-panel display attaches to an arm, letting people move the screen to their own eye level. The hemispherical computer base makes it easy to connect the iMac to digital cameras, printers, scanners, joysticks, and the iPod.



■ B R O N Z E

< MOUSEMAN TRAVELER

Designer:
Design Partners,
Ireland

*It's smaller
than the
average mouse
but does all
the things
mice do.
\$49.95*

G O L D

HANDSPRING TREO

Designer: IDEO
and Handspring
*The functions fit
into a compact
flip-top form
that is easy to
use and great to
look at. \$249*



■ B R O N Z E

> COMMAND CONSOLE

Designer: Vladimir
Rogov and Z
Microsystems

*This computer is
designed
for soldiers in
battle gear to
operate. \$6,000*

■ G O L D

< IMAC

Designer:
Apple Computer

*It's a dazzling
new shape
for the digital era.
\$1299-\$1799*

IBM PCs use genuine Microsoft Windows®

www.microsoft.com/piracy/howtotell

somewhere between surrealism and cubo-futurism

Lisa Dennison, *Chief Curator, Guggenheim Museum, New York City*

An optional portable 1GB hard drive that fits in the palm of your hand. A high-resolution screen that lets you see things as they are. **Intelligent design.** It's just one of the reasons why some of the world's most successful people choose ThinkPad® notebook computers. Select models feature a Mobile Intel® Pentium® 4 Processor-M for outstanding performance and mobility. Call **1.877.thinkpad** or visit **ibm.com/thinkpad/think**



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ANNUAL

DESIGN

AWARDS

GOLD

STX IGNITOR PROTECTION GEAR

Designer: Priority Designs
Lightweight, cool, flexible, padded protection for lacrosse athletes. \$250



Making Play Easy—and Stylish

CONSUMER

Get set for body armor for sports. The STX Ignitor Protection Collection uses foam technology to create a system of flexible pads and gloves for lacrosse athletes. Player research led to gear that provides both the needed mobility and protection. Previous padding was heavy and hot.

The Spyfish miniature remote-controlled sub has two video cameras, lights, a 500-foot cable line, and a display screen to show live images of the mysteries of the sea to people wanting to stay dry. A wireless remote allows one-handed control. Summer fun.

As is drinking wine. The Wine Celebration Funnel has a stylish art deco design and also aerates wine (in case you forget to open the bottle an hour before the steaks are ready on the grill).

The Talkabout T4300 Series is Motorola Inc.'s least expensive consumer two-way radio. The big "talk" button control right in the middle of the device makes it easy to use for kids—and adults. Good for hiking canyons or Disneyland.



SILVER

SPYFISH STV SUBMARINE

Designer: IDEO, U.S. and U.K.; H2Eye, U.K.
A sleek microsub can reveal the deep sea. \$14,900



BRONZE

TALKABOUT T4300 SERIES TWO-WAY RADIO

Designer: Motorola
It has a two-mile range and 14 channels. \$19.99

BRONZE

WINE CELEBRATION FUNNEL

Designer: Royal Selangor, Malay
It diverts the wine to the side cushioning it. \$



McGraw-Hill Education SHOWED HER HOW A BUILDING IS MADE.
STANDARD & POOR'S SHOWED HER HOW A COMPANY'S FUTURE IS MADE.
BUSINESSWEEK SHOWED HER HOW A REPUTATION IS MADE.



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Education

STANDARD
& POOR'S

BusinessWeek

platts

AVIATION WEEK

McGraw-Hill
CONSTRUCTION



A N N U A L

D E S I G N

A W A R D S



B R O N Z E



PRADA STAFF DEVICE

Designer: IDEO, UK; OMA/AMO, the Netherlands; Prada, Italy

Accesses customer preferences, sizes, what's in stock.



Tech Turns Up In Unlikely Places

TECHNOLOGY

Technology isn't only confined to computers. Prada has decided that high tech can enhance the high-end customer experience. The Prada Staff Device is a portable scanner that personal dressers carry with them as they shop with customers. It gives the staff access to data on shoppers' clothes preferences and sizes and shows what's in stock. The device also



controls in-store screens showing videos of models wearing clothes the customer might want. The device is light, simple to use, and easy to read. Linked to a shared software base with radio frequency (RF) tags on clothes and Customer Cards, it creates a



new shopping experience for Prada.

SenseWear Pro Armband collects clinically accurate data on everyday sleep quality, caloric burn, and activity levels. This helps doctors and researchers deal with patient insomnia, obesity, and weight gain. BodyMedia Inc. repacked several sensors into one easy-to-wear armband.

New Holland designed a more efficient, comfortable combine that can cut a broad, 42-foot swath of wheat. Smart ergonomics helps farmers who spend long hours in the cab during the harvest. A global positioning system and monitors keep the combine moving straight. A deck behind the seat provides a perch for the dog—and for food, water, and clothing.



G O L D



SENSEWEAR PRO ARMBAND MONITOR

Designer: BodyMedia and K-Development
Collects data on sleep quality, caloric burn, and activity. \$995



G O L D



NEW HOLLAND COMBI

Designer: Integrate and Round Industries
Design n driving t 13-foot- 30-foot- 34,600- machine more co \$200,00



C A T A L Y S T

A W A R D

The Aspect Medical Systems A-2000 Monitor, which anesthesiologists use to measure patient consciousness, is the winner of the new annual Design & Business Catalyst Award. Sponsored by the Industrial Designers Society of America and *BusinessWeek*, the Catalyst award is given in recognition of the business success of IDEA winners.

Design Continuum researched the behavior of nurses and doctors at Massachusetts General Hospi-

tal to design a small, easy-to-use monitor that tracks the effects of anesthesia on the brain. The device, which weighs three pounds, warns if patients are about to regain consciousness and allows for more precise—and often lower—doses of anesthetics.

The monitor won a bronze IDEA in 1999, and its marketplace success was a key factor in Aspect Medical Systems' decision to go public in January, 2000, when financing was beginning to get tight.



ASPECT MEDICAL SYSTEMS A-2000 MONITOR

Designer: Design Continuum
A simple sensor on the forehead tracks how well anesthesia is working. \$8,000





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Great products don't design themselves. To begin with, there are the freakishly super-human efforts of designers and engineers. Long days of concepting and sketching. Late nights of modeling, remodeling and eating leftover Moo Goo Gai Pan. There's the passion and focus that sometimes causes birthdays and anniversaries to be missed. There are administrators who miraculously manage to stop time and then stretch it. And we can't forget the consumers, who supply valuable feedback like, "I need a flexible chair that squirms when I squirm and sits up straight when I sit up straight." Input that can greatly determine design. There's research and development and overseas colleagues who weigh in with their own unique perspective. There are deadlines to meet. Requirements. Legalese. Critics. Good reviews. Bad reviews. Competition. Manufacturers, vendors, suppliers and model makers. There's the need for a simpler, better, more powerful way of designing an existing product. There are the little things in life that inspire the designers and the big ideas that they never thought were possible. There's new technology, software and coffee...that keep pushing the boundaries of what can be done and how fast. And then there are the people who buy it. Who take it home or to work, use it every day and make it possible for great products to be produced in the first place. So you see... great products really don't design themselves.

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And, of course, there are the companies themselves that, however different or edgy the design, have the unflinching courage to back it, believe in the product,

put their reputation on the line, the company name on the box and get it to the marketplace- while it's considered innovative. CEOs, COOs, presidents who realize that their product is the veritable heart of their corporation.

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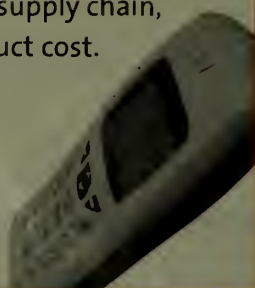
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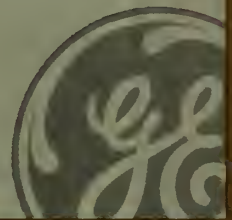


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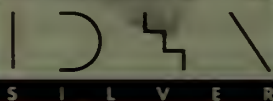
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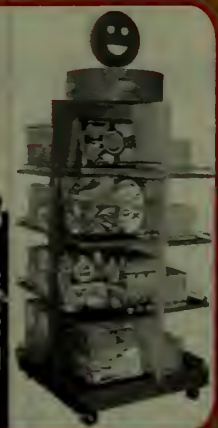
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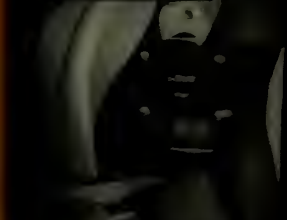
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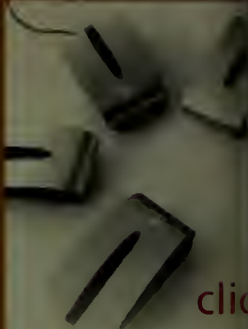
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Companies will be found in the **July 8, 2002** issue.



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BusinessWeek

Investor

MAKING LIFE RICHER



A Guide to AT&T and Its Offspring

■ Driving the New Baby Hummer

■ Barker: Get Tough, Janus

Ma Bell's Extended Family

After all the spin-offs, what should investors do now?

BY STEVE
ROSENBUSH

Owning shares of AT&T and its spin-offs has become a bewildering experience. Once regarded as the quintessential "widows and orphans stock," simple and safe enough for any investor, AT&T is now beyond the comprehension of many. It has morphed and merged and split so many times, longtime investors often don't know what they own. Anyone who held 100 Ma Bell shares on the eve of the original Jan. 1, 1984 breakup would now own 1,250 shares in 10 companies ranging from SBC Communications, AT&T Wireless, and Lucent Technologies to Qwest Communications, Agere Systems, and Vodafone.

The confusion is getting worse. A few months from now, AT&T is expected to complete the sale of its cable-TV unit to Comcast in a deal originally valued at \$72 billion. AT&T shareholders will get about one-third of a share in the new company for every share of AT&T they currently own. And as the troubled global telecommunications industry continues its consolidation, the pieces of the old Bell System will change faces in new mergers and acquisitions.

How have AT&T investors fared over the past 18 years? In a new report prepared for *BusinessWeek*, J.P. Morgan Chase determined that if you had 100 shares of AT&T in 1984, held onto all of its spin-offs, and took all of its dividends in cash, you would have just barely beat the Standard & Poor's 500-stock index. Assuming the cash dividends appreciated 3% a year, the AT&T portfolio would be worth \$46,758 today, up from \$6,350 on the share distribution date of Feb. 15, 1984, for an average annual return of 12%. The S&P 500 has increased 11.3% a year over the same period, not including dividends paid by constituent companies. If the S&P 500 dividends were thrown into the mix, the index would undoubtedly have beaten the performance of AT&T and its parts.

AT&T investors should have done much better. Since 1984, telecom industry revenues have risen from about 1% of gross domestic product to 3%,

says Marc Crossman, analyst for J.P. Morgan Chase, which has banking ties to AT&T for the years. "Given the telecom has been growing, you would have expected AT&T investors to have made boatloads of money," he adds.

Why didn't they? In hindsight, AT&T was taken up along the way by the lines. Nearly all of the stock market gains achieved by the M

pieces have occurred in the local phone market. Meanwhile, competition in the long-distance market has devastated AT&T. So instead of spinning off into seven local phone companies and continuing as a stand-alone long-distance company, AT&T should have just divided its long-distance business among the Bells.

So where does this leave investors? The telecom depression that began in 2000 is probably about half over. The boom lasted about 10 years, from 1996 to 2000, and the bust will probably last just as long as the industry works off excess network capacity. That means a telecom business recovery isn't likely until 2004 or later. And shares of AT&T and its spin-offs will probably underperform the market for more years, says Crossman, who has an "underweight" rating on the entire telecommunications sector.

The Bells are the best-timed companies of the industry. Their hard-to-duplicate lines are the key assets in the industry. They offer investors the greatest rewards, though not without risk. Revenue growth and profits are slow

as cell phones, cable modems, and e-mail eat at their dominance of the local phone business. Local revenue growth has shrunk from 7% in 2000 to just about flat for 2002, says Credit Suisse, a Boston analyst Dan Reingold. Yet they are the only companies with clearly enough cash to survive a long downturn. And their new line of business, from long distance to wireless phone and DSL, should pay off as the economy improves. Reingold has buy ratings on all the Bells.

BellSouth may be the surest bet because it has a strong balance sheet and little competition in hard-to-reach rural markets. Verizon and its competitors have national ambitions, and there's greater risk they will attempt a big acquisition that would dilute the stock. Plus, Verizon's debt level is about twice as high as BellSouth's. As for Qwest—a basket case. The combination of the Qwest long-distance service with the US West local-phone empire has created a nationwide monster with \$26.5 billion in debt. And the Securities &

A new report prepared
for *BusinessWeek*
shows that a pre-'84
investment would have
beaten the S&P

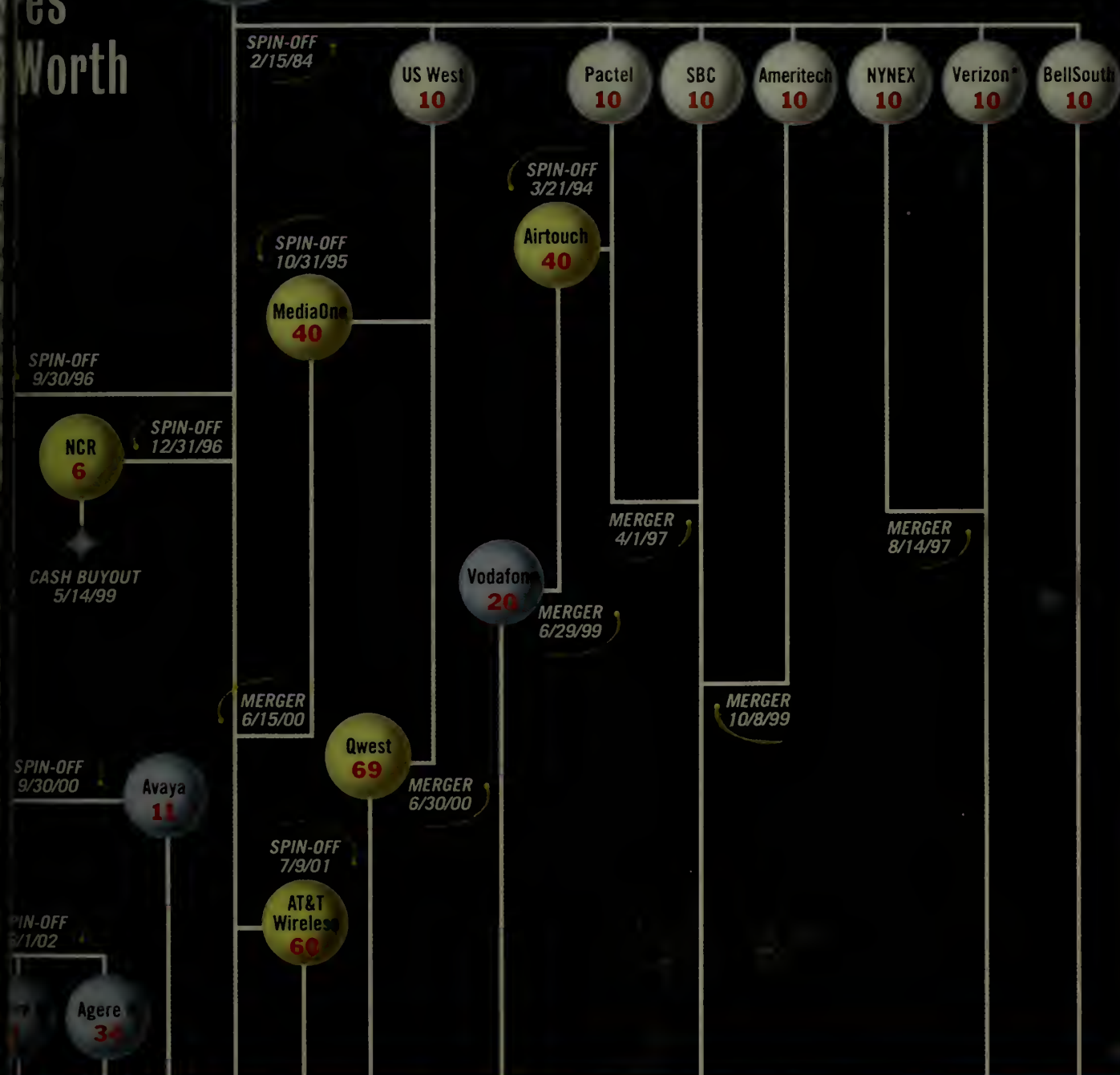
Much

es Worth

AT&T

100 SHARES
\$6,350 VALUE

If you owned 100 shares at the breakup in '84, you would own 1,250 shares spread over 10 companies. Your stake would have grown at a 12% annual rate, from \$6,350 to \$46,758, assuming you took dividends in cash and they appreciated at 3% a year. Here's what the galaxy looks like:



SHARES/VALUE**

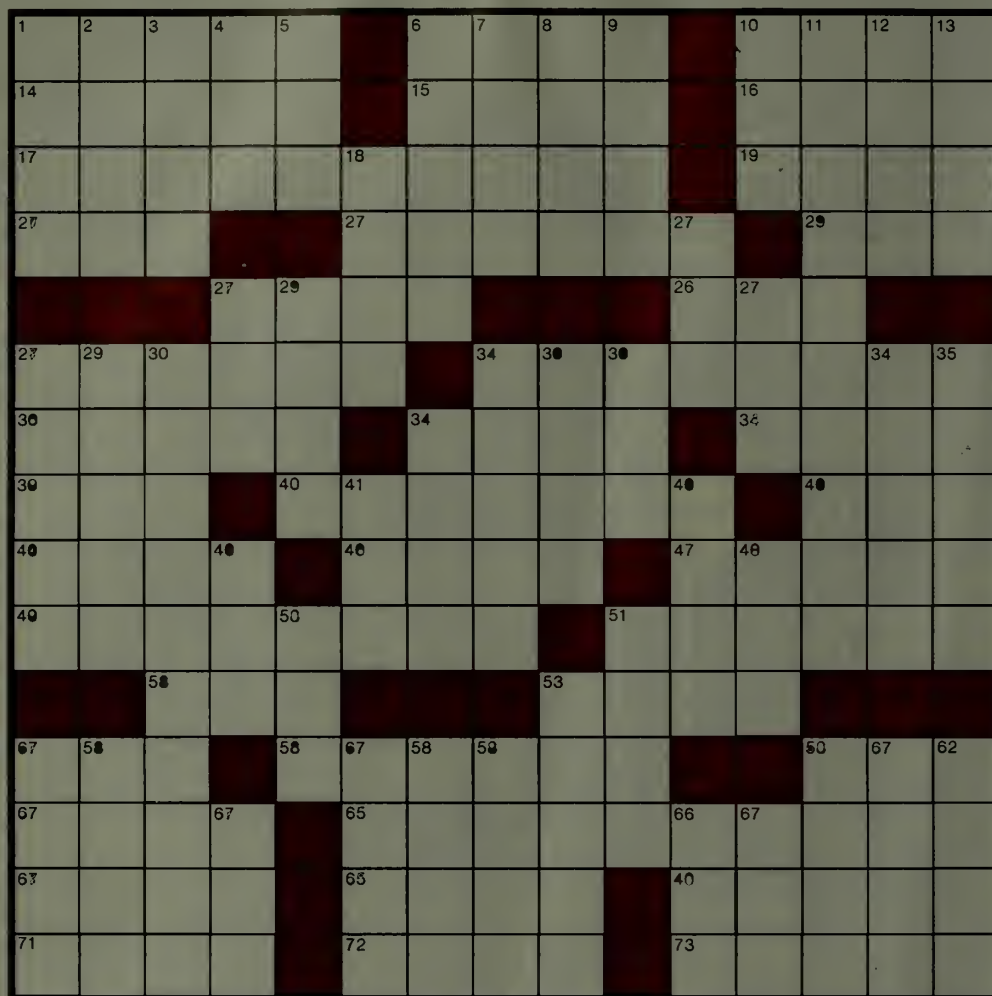
1	34	11	188	60	69	100	336	141	180
12	\$63	\$53	\$5,037	\$360	\$309	\$1,340	\$13,417	\$8,470	\$8,174

TOTAL VALUE
\$46,758***

* Bell Atlantic
** REFLECTS SHARE VALUE AS OF 6/24/02,
AND DIVIDEND VALUE AS OF 5/31/02

*** INCLUDES DIVIDENDS OF DISCONTINUED COMPANIES

Mixing Business with Pleasure by Lincoln



5. Fujitsu competitor
6. First American monopolist
7. Banquet platform
8. Teamwork inhibitors
9. Levelheaded
10. Fitness center
11. Part of IT
12. Palo __, Calif.
13. Dry run
18. Still sleeping
22. Sunblock letters
24. Mile High Center architect
25. Viscount's superior
27. "No __, ands, or buts!"
28. Hearty entree
29. Project part
30. What some nest eggs are
31. Hiding place
32. Author Hubbard
33. Kauai or Capri: Abbr.
34. Moscow money
35. Household appliance
37. __ even keel
41. Presidential nickname
42. Antidrug agent
45. Netscape owner
48. Prefix for classical
50. Dallas school
51. __ Rabbit (Harris character)
53. Highly skilled
54. California Perfume Company, today
55. Precious resource
57. Insect stage
58. Social slight
59. Not working
60. "Because there's rain, __ and groceries..." (see page at right)
61. End in __ (require overtime)
62. Roll-call count
64. Ticker symbol for Eisner's company
66. Typing-speed abbreviation
67. Aussie jumper

ACROSS

1. Sony's home
6. Citrus drinks
10. GDP, e.g.
14. Application
15. Long story
16. Brazilian soccer great
17. Transferred worker's activity
19. Pieces of legislation
20. Thanksgiving side dish
21. They're in charge
23. Selling very well
24. House of Lords member
26. 54 Across ID
28. Bid-asked difference
31. Income-shifting type of trust
36. " __ Finest Hour" (Churchill book)
37. Canoe paddles
38. Speak indistinctly
39. Have lunch
40. Sponsor of the page at right
43. Kimono sash
44. Where most people live
46. Carter "inflation czar"
47. Ulterior motive
49. J.D. Rockefeller's first successful product
51. Clinton Supreme Court appointee
52. Shade tree
53. Sinclair Oil buyer in 1970
54. 24-hour cash source

56. __ potential
60. Ell preceder
63. Competed
65. Be the backer for
68. Prefix meaning "all"
69. Paper mill's raw material
70. Speakers' platforms
71. Clears
72. Aid in wrongdoing
73. New York City's "Master Builder"

DOWN

1. Court group
2. En route via ship
3. Tropical tree
4. In the past

For answers to this puzzle:

Turn to page 115 in this week's issue of BusinessWeek or visit [Mixing Business with Pleasure by Lincoln](http://www.businessweek.com/adsections) on www.businessweek.com/adsections

Puzzle created by: Stanley Newman.



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change Commission is reviewing its accounting practices, creating more uncertainty for investors.

The outlook for the telecom-equipment side of the old AT&T empire is tough. The Bells' troubles have caused misery for Lucent Technologies, formed in 1996 when AT&T spun off its manufacturing operations and Bell Labs research. Lucent's fortunes soared for nearly four years after the spin-off. But as many smaller customers, such as Winstar Communications, went bankrupt, Lucent went into the red.

Making matters worse, big Lucent customers such as Verizon and SBC began cutting back on spending, too. Overall, capital spending by North American telecom carriers fell 5% in 2001 and will decline an additional 29% in 2002, according to the Dutch bank ABN Amro. Growth is unlikely to resume until carriers begin to recover and resume spending, most likely in 2004 or 2005.

Yet some investors with a long horizon sense a bargain. Lucent shares have dropped from a high of \$86 in 1998 to a low of \$2.28 on June 24. If spending on telecom equipment does pick up in 2003 or later, Lucent stands to benefit. Kevin Rendino, who manages \$13 billion in value funds for Merrill Lynch, compares today's tech malaise to the banking crisis of the late 1980s, when

Citigroup traded at a split-adjusted price of \$2 a share. He thinks Lucent is in similar territory and a bargain at less than \$3 a share. He does expect things to get worse at Lucent before they get better later this year or next, when its largest customers boost their tech spending.

The prospects for AT&T's former wireless unit aren't trouble-free, either. AT&T Wireless is expected to boost 10% to 12% this year. That's less than the forecast of 12% to 14% growth for 2002, according to Lehman Brothers wireless analyst Bensche. Price pressure has pushed average revenue per user down. And AT&T Wireless is up a lot of debt from its former parent. Wireless' earnings-to-interest expense is 8.3—four times higher than Sprint PCS's of 2.1. It also faces huge costs in upgrading its network for more voice and data calls. Given these challenges, investment-banking sources expect AT&T Wireless to find a merger partner, creating an opportunity for an arbitrage play. The most likely buyer is No. 2 carrier Cingular, which uses a similar digital standard, making integration possible. But AT&T Wireless could also

Investors with a long horizon sense a bargain at less than \$3 a share.

AT&T's Investment Legacy

Here's what to expect from Ma Bell and the companies she hatched since the Bell System breakup in 1984:

AT&T Business is suffering from weak demand for voice and data long distance. But rivals WorldCom and Sprint are laboring under bigger debt loads, and the decline in long-distance prices has slowed. There's potential upside to AT&T. Long run, it's likely to be acquired.

AT&T WIRELESS 2002 revenue growth is forecast at 10% to 12%, down from earlier estimates of 12% to 14%. The debt-to-earnings ratio is four times higher than Sprint PCS's. A merger with Cingular or Nextel is a welcome possibility this year or next.

AT&T BROADBAND The cable unit is expected to merge with Comcast later this year. The new AT&T Comcast will be saddled with \$30 billion in AT&T debt, yet profits are forecast to grow 15%.

THE BELLS Local-phone giants BellSouth, Verizon, and SBC are the best-positioned companies in telecom, even though revenue and profit growth are slowing under pressure from wireless phone companies, cable TV, and e-mail. Qwest is a basket case—it's burdened with debt.

LUCENT TECHNOLOGIES Orders are way down for Lucent and its spin-offs—chipmaker Agere and office-phone supplier Avaya. The question is, can Lucent survive until telecom capital spending picks up?

Data: J.P. Morgan Chase, ABN Amro, Merrill Lynch



buying debt-laden Nextel Communications, analysts say. That could be a boon for AT&T Wireless shares.

And the cable business? To AT&T Broadband and Comcast, revenue growth is expected to be 9%. All of that comes from cable modem and cable-phone sales. The combined company's \$30 billion in debt has frightened Comcast investors. Its shares have dropped to \$25 from \$39 since last year. Analysts see little near-term upside for the new company, which will be called AT&T Comcast. And some fear the deal could fall through if Comcast loses its investment-tier credit rating. Others believe the stock could pay off if cable earnings grow by 15% as promised. S.C. Bernstein & Co. rates it "outperform."

The prospects for AT&T itself are better than they have been in some time. The company will emerge from the cable sale with a manageable \$18 billion in debt, down from a high of \$65 billion in 2000. With WorldCom and Sprint still mired in debt and suffering from weak market conditions, AT&T has an opportunity to grab share in Internet services and communications to big corporations. Morgan's Crossman thinks shares of the telecom unit, excluding cable, can double from \$2.80 to about \$6, in the next 12 months. That, chances are, AT&T will be acquired. The Bells win permission to enter the long-distance market in more states. And that, of course, reunites Ma Bell with her offspring.

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More Sport, Less Utility

The Hummer SUV is macho, all right, but it falls short where other SUVs excel

BY DAVID WELCH

General Motors' all-new Hummer H2 is the ultimate sport-utility vehicle. The more urbane follow-up to the militaristic H1, the H2 chugs fuel and hogs the road. It also plays up the rough-and-tumble SUV image: The thing is capable of rolling over terrain that even most army recruits will never see.

I spent an entire day driving the H2 on an off-road course outside South Bend, Ind., where military contractor AM General builds both Hummers for GM. Before that, I toiled around Detroit highways in a fire-engine-red H1, a street-legal version of the army's Humvee assault truck. The H2, with its \$48,800 base price, is much more drivable than the \$113,000 H1 and far more distinctive than the copycat SUVs on the road. GM hopes to sell 40,000 of the H2s a year, vs.

only 770 for the full-blown H1. But the "hummer" strikes out where other big SUVs thrive. It seats just six instead of eight or nine, has virtually no storage space despite its pulent frame.

The H2 is at its best driving through deep woods—where GM estimates that only 10% of its image-conscious buyers will go. At the AM General course, I drove up a steep hill. I had an eerie feeling that the H2 would backslide, clawed the dirt and kept powering up until it hit the crest and immediately rolled down into a deep gully, riding the brakes until the fat tires splashed down in the mud at the bottom. At this point, I was staring through

2003 HUMMER H2

BASE PRICE
\$48,800



field straight down and couldn't see any-
out the floor of the soupy trail. Then I
the accelerator and my vehicle slowly
up and out of the steep ditch. In sec-
ny view changed from the bottom of a
o a patch of blue sky between boughs of
s. Neither end of the H2 hit the ground.
est the H1 and H2, AM General runs its
ver huge, jagged rocks. For the H1,
carriage clears 16 inches, it's a cinch.
hicle's essential hardware, such as the
ission and axles, is tucked up high in
ck, taking up the space between the
The H2, with just 10 inches of ground
ce, has a steel plate bolted on the belly
truck to shield it during off-road driving.
ed the H2 along the rocks, wincing at
l-on-blackboard screech of the steel plate
g the ground. But the H2 continued on
t damage.

all of its brawn, the H2 is surprisingly
on the highway. I drove it a couple of
from Chicago to South Bend, getting all
f surprised looks from other drivers, most
m probably have never seen an SUV like
. The ride is quiet, too. I could carry on a
sation easily with the other passengers. I
ted morning traffic in Chicago and found
ack no more difficult to park or maneuver
in any large SUV. The reason: It's almost 7
et wide and 16 feet long, but it's still 9
ches shorter than a Chevrolet Tahoe and
15 inches shorter than Ford's new Expe-
dition. Still, don't try to make a tight U-
turn in this truck. With the wheels
pushed to the corners, the H2 needs
even more space to turn than GM's long
Chevrolet Suburban.

The truck is comfortable. Since the
H2 uses 40% of the parts from GM's
Chevy Tahoe and GMC Yukon SUVs, it
rides on the road like any other people-
hauler. The H2 sits a couple of inches

higher than a Tahoe,
and driving it feels
very commanding.
The truck is genera-
tions beyond the H1,
which nearly deafens

drivers with the loud hum of the tires
and the clatter of its huge diesel engine.
The H2 has great brakes, too, that stop
its 6,400 lb. easily. The H1 also stops
well, but the 7,100-lb. truck actually rocks
front to back on its loose suspension for a
few seconds after stopping.

The H2 interior is a real letdown. While
managed to keep the outside looking like
original H1, inside it lacks the one truly
thing about the H1—its military gauges
thentic Army-truck feel. For instance, in
1, you get big, durable switches that let
iver toggle over to the reserve fuel tank
ust the tire inflation for highway or trail
g. The H2 has a manual pump in the rear
ate or deflate the tires, but it's an acces-



sory, not a gadget controlled from the cockpit.
The H2's controls use the same cheap plastic
knobs, buttons, and trim that GM incorporates
into its other SUVs. The round, softball-size vents
in the dashboard, for instance, are straight out of
the \$22,000 Pontiac Aztek. The leather seats,
however, are plush, just like a Yukon or a Cadil-
lac Escalade.

Considering that the H2 is pitched to compete
with big SUVs, there's not much utility to it. The
truck's 35-inch tires are so big that the spare
takes up almost all of the space behind the sec-
ond row of seats, save one small seat for a sixth
passenger. Measured in cubic feet, the H2 has
half the Tahoe's cargo volume.

It can't tow as much, either. Despite its 6-
liter V-8 engine, the 316-horsepower H2 loses to
the Tahoe when it comes to pulling a trailer.
That's mostly because the hardware that makes
it an off-road star—such as the steel plate be-
neath the truck—also makes it 1,400 pounds
heavier than ordinary full-size SUVs. So the H2
spends a lot of energy just pulling its own

Despite its corpulent frame, the H2 has virtually no cargo space—and the cheap plastic dashboard setup is more like a Pontiac Aztek than a Hummer

weight—getting 12 miles per gallon at best.

So why buy it? The H2's boxy, tough profile
makes the vehicle stand out from the SUV
crowd. Like the H1, it has a fearsome grille,
and the front windshield is almost completely
vertical, giving it a military presence. Arnold
Schwarzenegger drives an H1 and has offered
to buy the first H2 that rolls off the assembly
line. "Don't call it the baby hummer," Arnold
warns in a promotional video. "You'll make
it angry."

In other words, the H2 is all about feeling
tough. Where the H1 is like a "No Fear" window
sticker for people with lots of money, the H2
makes a masculine style statement but with a lot
more comfort. Just don't expect it to be the
family hauler your Chevrolet Suburban is. ■

2002 HUMMER H1

BASE PRICE
\$113,000

TIME TO SAVE FACE AT JANUS?



BY ROBERT BARKER

rb@businessweek.com

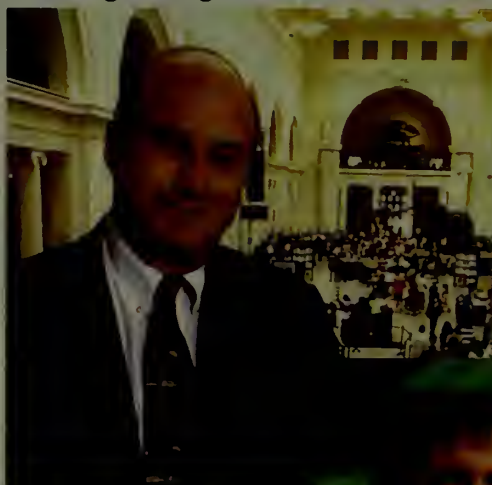
Janus Capital's recent work for fundholders looks mediocre, at best. But it's unlikely the trustees will even consider a new management company

Are Janus funds getting a fresh start? News that founder Thomas Bailey is quitting on July 1 as CEO of Janus Capital Management suggests changes for Janus' \$131 billion fund complex. The next CEO has yet to be named. Lots of Janus' four million investors would no doubt welcome new leadership. Many Janus funds have been bleeding through the bear market, in part from getting caught with big stakes in the likes of AOL Time Warner and Tyco.

Don't count on seeing much change any time soon, though. Bailey is staying on as chairman of the board of trustees (table), which by law is supposed to serve as every Janus fund investor's watchdog. Under the board's own retirement policy, Bailey could remain chairman for another eight years.

Nothing wrong with that, necessarily. But if I were a Janus investor, I wouldn't want to wait until 2010 to see the trustees shake things up a little. Each year, every fund's board must decide whether to renew its management contract with the fund's investment adviser, in this case Janus Capital. While it may not be practical for the trustees to yank billions from Janus Capital, they could take steps to show that better performance is on the way.

Even if you set aside big blow-ups such as Tyco and Enron, Janus Capital's returns are mediocre at best. Morningstar puts four of Janus'



WATCHDOGS: McCarter (above) and departing Janus CEO Bailey

five biggest funds in the bottom quartile past year's performance. Over the past years, just one is ranked above average.

Given these reasons for fundholder I wondered if the trustees were growing chanted with Janus Capital. Bailey declined comment. But Martin Waldinger, a longtime friend and trustee, told me: "We have had a bad run, but I don't think there's anything wrong at Janus. They made some bad investments, or they made some investments that went against them." Finding a new adviser, added, is "not even close" to being the trustees' agenda, despite redemptions that slashed assets under management.

Waldinger is one of several independent trustees responsible to Janus investors. Whether the other investors agree with him, I cannot say. Only one, John McCarter, turned my call: He pleaded ignorance, having just joined the board. In any case, the trustees recently voted to renew Janus Capital's contract for another year. Cameron Avery, the

independents' lawyer, says they focus on the performance "and every board member is interested in doing it publicly." "It's not easy for the world to take performance in hindsight, at least not performance said.

True enough. Yet it's also hard to see how fundholders would be hurt if Janus Capital's annual contract renewal weren't such a slam dunk. What might the trustees do instead? Consider USAA Funds. The adviser, USAA Investment Management, manages \$28 billion in assets, including \$7 billion in stock funds. The USAA trustees, uneasy with the stock funds' lack of showings, were set to consider on July whether to dump USAA as the adviser. "The view is to determine if we can provide consistent above-average performance by seeking external [investment advice]," a spokesman said.

Translation: USAA's trustees have opened their minds to other ways of delivering what clients want. Janus' trustees don't have to open for bidding the contract to run all 52 funds they oversee. But why not find a new management company for a troubled fund, such as a billion Janus Enterprise? A bit of fresh thinking would go a long way toward assuring investors their watchdogs aren't fast asleep.

The Buck Stops Here

Here are the trustees overseeing Janus' \$131 billion in mutual-fund assets. They can be contacted c/o Janus at 100 Fillmore St., Denver, Colo. 80206

TRUSTEE	AGE	OCCUPATION	TRUSTEE SINCE
THOMAS BAILEY	64	Janus CEO, retired*; trustees' chairman	JUNE, 1969
WILLIAM McCALPIN	45	COO, The Rockefeller Brothers Fund	JUNE, 2002
JOHN McCARTER JR.	64	CEO, Field Museum of Natural History	JUNE, 2002
DENNIS MULLEN	58	Investor	FEB., 1971
JAMES ROTHE	58	Business professor, University of Colorado	JAN., 1997
WILLIAM STEWART	57	Executive, MKS Instruments - HPS Products	JUNE, 1984
MARTIN WALDINGER	63	Retired	AUG., 1969

*Retirement from Janus Capital as of July 1, 2002

Data: Company reports, BusinessWeek

BusinessWeek online

For barker.online, go to www.businessweek.com/investor/ and click on "Col

AT&T: SET TO BOUNCE



Gene G. Marcial

players rush
Comcast-
need AT&T.
ch rebounds,
dFam-IPEC
um. ViroLogic
are a boon in
prescribing

What to do after the debacle at No.2 WorldCom? Buy stock in global No.1 AT&T (T). Some value players are now loading up on the phone company, which has been on the ropes for a year (page 104). Shares are at 9.62, down from nearly 20 in December. What's the lure?

These pros aren't after AT&T's phone business. They expect extra value in the struggling giant because of Comcast. In December, AT&T agreed to sell its cable-TV business to Comcast in a \$72 billion deal closing at yearend, 2002. Combining AT&T's 13.4 million broadband subscribers with Comcast's 8.5 million makes Comcast No.1, with a total of 22 million.

AT&T shareholders will get a third of Comcast stock, which would add \$7.50 to the worth of each AT&T share, based on Comcast's price of 23, figures John Maloney, president of M&R Capital, which has been buying into AT&T. Comcast has fallen 35% this year, so it's depressed relative to assets, he says.

Maloney figures Comcast's true worth is 35, which would boost its contribution to each share of AT&T to 11.40. He estimates the value of the AT&T "stub" (the remaining value of AT&T's phone business after the cable sale) at 4 a share: Adding the two brings AT&T's value up to 15.40.

Phone stocks are down because of general turmoil in the industry. But in the wake of the WorldCom disaster, says Maloney, its business clients will flock to AT&T, whose capital structure is sound. AT&T, which posted revenues of \$53 billion last year and earned 23¢ a share from operations, is expected to do a 1-for-5 reverse stock split after the Comcast deal. Comcast posted revenues of \$9.6 billion last year and net income of \$608.6 million, or 63¢ a share. Maloney thinks Comcast's financials are sound: It has a stable cash flow and—despite the cable deal—its debt burden "isn't troubling to us," he adds.

SPEEDFAM'S CHIP MACHINES REV UP

Most tech stocks are pariahs these days, but Arnold Schmeidler, president of money-manager A.R. Schmeidler, is betting big on SpeedFam-IPEC (SFAM), a pioneer in "chemical mechanical planarization" (CMP) systems, used in making advanced semiconductors. Now at 4.60 a share, the stock could double in a year, he says.

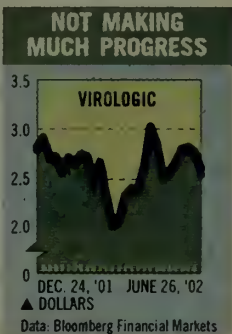
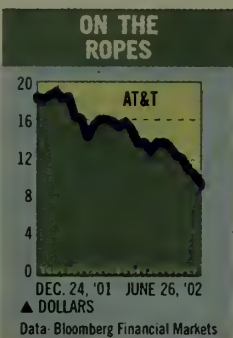
SpeedFam's machines, costing \$3 million to \$4 million apiece, yield extremely

flat, smooth wafers for making advanced chips. A chip factory easily uses 20 machines, says Schmeidler, whose firm has acquired a 7% stake in SpeedFam. Its new CMP platform, Momentum, offers low-cost but superior technical capability, he says, especially in copper-wafer processing. "With 1,300 CMP machines currently in use at various chipmakers, SpeedFam could up its share of the \$1.6 billion market from 10% to 30% in three years," says Schmeidler. Six of the top chipmakers are SpeedFam customers, including Samsung and Taiwan Semiconductor. Sales will ramp up fast, says Schmeidler, as the economy rebounds and as chipmakers seek next-generation CMPs.

Schmeidler figures that on July 2, SpeedFam will report better-than-expected results for the year ended May 31, 2002. Analysts expect a loss, on estimated sales of \$115 million. In fiscal 2003, Schmeidler sees earnings of \$32 million, or \$1 a share, on sales of \$150 million. Based on such growth, he thinks the stock is worth 10. In fiscal 2004, he sees profits jumping to \$2 to \$3 a share, on sales of \$200 million to \$300 million. His 24-month price target: 20.

VIROLOGIC: A BIG GUN IN THE HIV BATTLE

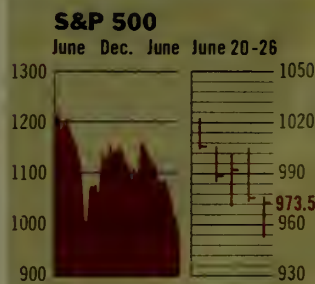
ViroLogic is a small biotech player in the fight against HIV, the virus that causes AIDS. Its stock trades at 2.55. But ViroLogic partners include Merck, Pfizer, and GlaxoSmithKline. It has developed technologies to assess drug resistance to specific viruses. ViroLogic's novel HIV-testing technology, PhenoSense GT, is being used by Pfizer for its HIV drug-discovery program. The PhenoSense products "are designed to help drug-makers screen HIV clinical-drug candidates faster and more efficiently," says Matt Geller of CIBC World Markets, which handled ViroLogic's initial public offering two years ago. There are 16 approved HIV drugs and 40 more in the pipeline. ViroLogic's patented technology can be applied to new HIV drug targets and is also being modified for use in vaccine research against HIV, says Chief Financial Officer Karen Wilson. She says ViroLogic is in talks to sign up vaccine makers as partners. Geller figures ViroLogic, which will post a loss this year on sales estimated at \$38 million to \$42 million, will earn 34¢ a share in 2003, on sales of \$85 million. One hedge fund manager, who has been buying, has a target of 8, based on ViroLogic's exceptional sales growth and partnerships with big drugmakers.



BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:45 p.m. EST on CNNfn's *The Money Gang*.

Stocks



COMMENTARY

The U.S. stock market, already down for most of the week, was pushed lower by the scandal at WorldCom. U.S. Treasury yields of two-year notes fell to a two-month low on June 26, as investors fled to safety. The dollar fell to a 28-month low after the scandal hit the news. The Standard & Poor's 500-stock index fell to 973.5, its lowest level since September. European shares tumbled.

Data: Bloomberg Financial Markets
Reuters

U.S. MARKETS

	June 26	Week	Year to date	Last 12 months
S&P 500	973.5	-4.6	-15.2	-20.0
Dow Jones Industrials	9120.1	-4.6	-9.0	-12.9
Nasdaq Composite	1429.3	-4.5	-26.7	-30.8
S&P MidCap 400	479.8	-4.6	-5.6	-5.0
S&P SmallCap 600	226.0	-2.6	-2.6	2.4
Wilshire 5000	9222.3	-4.5	-13.9	-18.1

SECTORS

	June 26	Week	Year to date	Last 12 months
BusinessWeek 50*	611.1	-5.9	-16.3	-28.1
BusinessWeek Info Tech 100**	293.1	-4.6	-30.1	-35.4
S&P/BARRA Growth	489.4	-4.2	-17.7	-19.7
S&P/BARRA Value	481.1	-5.0	-12.9	-20.8
S&P Energy	212.3	0.1	0.5	-10.8
S&P Financials	327.0	-5.4	-8.0	-14.1
S&P REIT	101.6	0.8	8.7	8.2
S&P Transportation	190.3	-4.1	-3.4	0.7
S&P Utilities	120.3	-5.1	-17.5	-34.4
GSTI Internet	70.5	-11.1	-32.8	-46.3
PSE Technology	501.1	-6.4	-27.1	-28.9

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Railroads	2.1	68.9
Oil & Gas Refining	1.6	46.4
Managed Health-Care	1.4	40.2
Homebuilding	1.4	39.1
Specialty Chemicals	0.3	38.8

EQUITY FUND CATEGORIES

4-week total return	%	52-week total return	%
Leaders			
Real Estate	2.0	Precious Metals	71.1
International Hybrid	-4.5	Real Estate	15.5
Domestic Hybrid	-5.1	Pacific/Asia ex-Japan	6.6
Financial	-5.2	Small-cap Value	5.3
Laggards			
Technology	-17.7	Communications	-44.8
Communications	-17.1	Technology	-42.5
Latin America	-17.1	Health	-26.5
Health	-12.7	Utilities	-24.4

EQUITY FUNDS

4-week total return	%	52-week total return	%
Leaders			
Rydex Dynamic Vent. 100	43.6	U.S. Glob.Wld. Prec. Mins.	107.3
ProFunds UltraShort OTC	43.4	First Eagle SoGen Gold	102.7
Potomac OTC Short	20.5	U.S. Global Investors Gold	97.9
Rydex Arktos Investor	20.5	Van Eck Intl. Invs. Gold A	93.1
Laggards			
ProFunds UltraOTC Inv.	-33.9	ProFunds UltraOTC Inv.	-73.1
Black Oak Emerging Tech.	-29.9	Black Oak Emerging Tech.	-69.1
iShares Gold. Sachs Netwkg.	-28.2	Van Wagoner Post Venture	-65.1
iShares Gold. Sachs Semicr.	-25.2	Van Wagoner Technology	-63.8

GLOBAL MARKETS

	June 26	Week
S&P Euro Plus (U.S. Dollar)	968.8	-2.3
London (FT-SE 100)	4531.0	-2.6
Paris (CAC 40)	3701.1	-6.0
Frankfurt (DAX)	4099.1	-5.9
Tokyo (NIKKEI 225)	10,074.6	-3.8
Hong Kong (Hang Seng)	10,355.9	-3.0
Toronto (TSE 300)	7021.0	-3.1
Mexico City (IPC)	6171.6	-7.8

FUNDAMENTALS

	June 25	Wk.
S&P 500 Dividend Yield	1.62%	1
S&P 500 P/E Ratio (Trailing 12 mos.)	41.9	4
S&P 500 P/E Ratio (Next 12 mos.)*	17.3	1
First Call Earnings Revision*	-0.84%	-0

*First Call Corp.

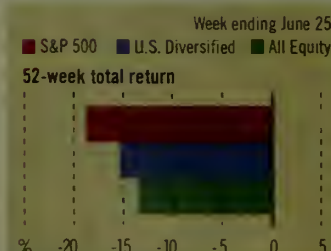
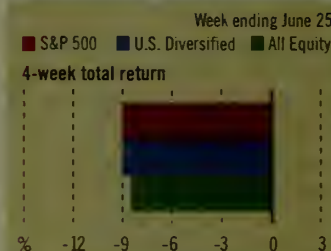
TECHNICAL INDICATORS

	June 25	Wk.
S&P 500 200-day average	1102.6	1106
Stocks above 200-day average	56.0%	64
Options: Put/call ratio	0.95	0.9
Insiders: Vickers NYSE Sell/buy ratio	4.02	4.7

WORST-PERFORMING GROUPS

	Last month %	Last 12 months %
Wireless Services	-39.9	Multi-Utilities
Advertising	-35.2	Wireless Service
Semiconductors	-30.2	Computer Stge. &
Broadcasting & Cable TV	-27.6	Telecomms. Equip.
Telecomms. Equipment	-27.0	Application Softw

Mutual Funds



Data: Standard & Poor's

THE WEEK AHEAD

CONSTRUCTION SPENDING Monday, July 1, 10 a.m. EDT ► Building outlays are forecast to have inched up 0.3% in May after a 0.2% gain in April. That's based on the median forecast of economists surveyed by Standard & Poor's MMS, a division of The McGraw-Hill Companies.

PURCHASING MANAGERS' INDEX Monday, July 1, 10 a.m. EDT ► The Institute for Supply Management's industrial activity index probably slipped to 55% in June, from 55.7% in May. While production and

new orders are increasing, only a few sectors are hiring additional workers.

VEHICLE SALES Tuesday, July 2 ► Sales of U.S.-made and imported cars and light trucks probably totaled an annual rate of 16.4 million units for June, after falling to an annual rate of 15.5 million in May. Through May, vehicle sales are on a healthy yearly pace of 16.3 million units.

FACTORY INVENTORIES Wednesday, July 3, 10 a.m. EDT ► Manufacturing inventories

most likely fell 0.4% in May, for 0.2% decline in April.

EMPLOYMENT Friday, July 5, 8:30 ► Nonfarm payrolls in June most increased by 68,000 jobs, after 41,000 positions during May. F. payrolls are forecast to have fallen additional 10,000 jobs. The unemployment rate is expected to inch back to 5.9%, from 5.8% in May. The average workweek probably remained unchanged at 34.2 hours.

Interest Rates

KEY RATES

	June 26	Week a
MONEY MARKET FUNDS		
90-DAY TREASURY BILLS	1.47%	1.51%
2-YEAR TREASURY NOTES	1.69	1.70
10-YEAR TREASURY NOTES	2.75	2.77
30-YEAR TREASURY BONDS	4.74	4.73
30-YEAR FIXED MORTGAGE†	5.43	5.39
	6.54	6.55

†BancQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 30% federal tax rate.

	10-yr bond
GENERAL OBLIGATIONS	4.09%
TAXABLE EQUIVALENT	5.84
INSURED REVENUE BONDS	4.27
TAXABLE EQUIVALENT	6.10

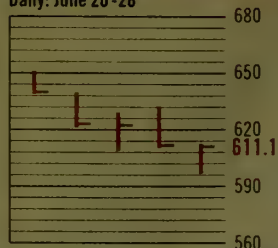
BusinessWeek Fifty

Dec.

June

Weekly

Daily: June 20-26



the BW 50, whose 5.9% decline lagged the major market indexes by a full percentage point. It tumbled 18.1% on liability concerns, and scandal-racked Tyco International plummeted 33.6% after a rating downgrade. Citigroup, troubled by loans, tumbled 12%. Such losers easily outweighed the few bright spots, such as Bed Bath & Beyond.

COMPANY PERFORMANCE

% change			% change			
	Week	Since 3/1/02	Rank	Company	Week	Since 3/1/02
Johnson	-4.0	-11.1	26	Tenet Healthcare	-8.0	24.4
	-7.3	-5.2	27	Household International	-5.6	-5.5
	-2.1	-14.6	28	WellPoint Health Networks	-8.1	30.3
	-5.1	-8.2	29	Washington Mutual	0.6	15.7
	-18.1	-14.5	30	Duke Energy	-4.7	-11.4
	-8.0	-24.7	31	Kohl's	-5.3	3.2
	-6.9	-6.8	32	Bed Bath & Beyond	7.4	10.5
	-2.1	-1.9	33	Cardinal Health	-4.2	-6.7
	-7.6	-20.3	34	Centex	-1.1	-4.3
	-6.9	13.1	35	American Electric Power	-4.3	-8.7
Group	-6.5	25.5	36	Golden West Financial	-2.1	5.6
	-4.8	4.8	37	Stryker	-3.2	-14.6
	-2.9	-26.9	38	Harley-Davidson	-4.2	-2.5
res	-3.1	-10.3	39	PepsiCo	-5.1	-2.5
	-19.1	-75.6	40	Merck	-4.2	-17.9
	-4.1	13.4	41	Apache	3.1	8.3
amics	0.9	-2.9	42	Amerada Hess	1.6	14.5
oleum atories	-2.2	-11.5	43	KB Home	2.6	18.3
	-2.4	-10.7	44	First Data	-6.9	-8.6
	-33.6	-20.5	45	Tyco International	-22.6	-58.8
	0.1	11.3	46	International Game Technology	-6.1	-18.5
etroleum	-3.9	-10.3	47	Capital One Financial	-3.3	15.3
	2.5	10.9	48	Electronic Data Systems	-10.3	-26.5
	-1.6	-4.1	49	Nabors Industries	-5.5	1.7
	-12.0	-18.2	50	Xcel Energy	-16.3	-34.1

Production Index

Change from last week: 0.3%
Change from last year: -4.1%

OUTPUT June 15=162.0 1992=100
Index is a 4-week moving average



Index rose during the latest week. Behind the four-week moving average, the index rose 0.3% from 162.5 to 162.6. On a seasonally adjusted basis, steel output showed the strongest increase, up 1.2% from 162.5. On a seasonally adjusted basis, railfreight traffic were also positive, up 0.5% from 162.5. Lumber output was nearly unchanged. Lumber followed by a sizable drop in autos and electric-power production and crude-

of the index components is at www.businessweek.com. Copyright 2002 by The McGraw-Hill

Online Resources

BW 50 Track the index and the companies in it all day long. Plus: our exclusive Info Tech 100 index.

BUSINESSWEEK INVESTING Real-time market coverage and investment tools in partnership with Standard & Poor's.

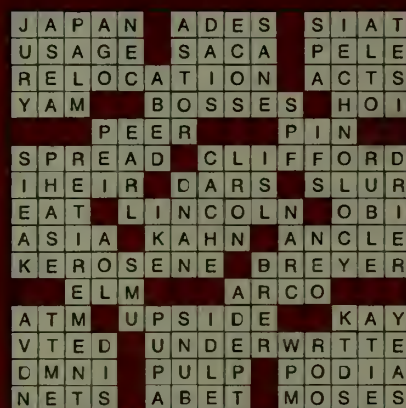
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THIS ECONOMY CAN SURVIVE THE SCANDALS

The June 25 admission by telecom giant WorldCom Inc. that it had cooked its books to the tune of at least \$4 billion could not have come at a worse time for the economy and for the stock market. Even before the WorldCom news came out, the S&P 500-stock index had already fallen by 15% this year. The dollar was declining against the yen and the euro, consumer confidence was weakening, and fears were building that the recovery would be weaker than expected.

It would be understandable at this point for investors to feel betrayed by Corporate America and distrustful of anything that executives told them. And it would be equally understandable if investors withdrew their money from equities, fearing the next revelation of corporate malfeasance. After all, the fraudulent behavior seems to be getting more and more blatant. Every time we think we have seen it all, a worse example comes along.

But people need to remember something very important: One of the great virtues of the U.S. economy over the past 20 years has been its ability to successfully deal with a wide variety of seemingly intractable economic and financial problems. The list starts with the runaway inflation of the early 1980s, vanquished far faster than economists expected. It includes the savings and loan crisis, the threat from foreign competition in the '80s, the 1987 stock market crash, the 1997 Asian financial crisis, and the 1998 failure of Long-Term Capital Management. Each time, there was a recognition—perhaps delayed—that there was a serious problem. That was followed by a willingness, on the part of both the private and public sectors, to do what needed to be done.

Today's crisis is following the same pattern. It took a while

for regulators, politicians, and corporate leaders to reach the depth of the problem with corporate lying and fraud. But gradually there has been action, with the New York Stock exchange, the Securities & Exchange Commission, Standard & Poor's, and the Conference Board all putting forth or about to promulgate new standards. Congress is seriously considering accounting reform. And the issue is finally getting on the radar screen of the Bush Administration. President George W. Bush said on June 26 that he was "deeply concerned" about some of the accounting practices that take place in America.

None of these steps will have an effect overnight, but cumulatively they're changing the ground rules for corporate behavior. CEOs are being put on notice that the sort of moral and illegal behavior that pervaded Enron and WorldCom will no longer be winked at. More scandals from the past may still emerge, but it will be far less likely that companies will make aggressive accounting a key part of their financial strategy, as these companies did.

While the short term may be rocky, there's little doubt that the U.S. economy—and the stock market—will not only survive the current crisis but will thrive in the long run. The economy is showing good fundamental strength, with productivity growth strong and manufacturing recovering, while the market may not be at bottom yet, over the long run, stocks will rise if the economy does well.

The big danger is that investors who displayed irrational exuberance in the 1990s will swing the other way and succumb to irrational negativism. Skepticism is appropriate, but withdrawal isn't. The U.S. economy has a resilience that should not be underestimated.

MEDIA: THE DANGERS OF CONCENTRATION

Even while the Securities & Exchange Commission is trying to get the excesses of the market under control, another government agency could be opening the door to another kind of excess. The Federal Communications Commission announced on June 17 that it was starting a consolidated review of all the rules limiting how many radio stations, newspapers, and TV stations a single company can own, both nationally and in a single market.

This review is likely to lead to a dramatic deregulation of ownership restrictions. FCC Chairman Michael K. Powell favors relaxing limits on the ability of separate industries, such as broadcast and cable, to merge. In addition, he opposes limits on the size of media companies. Meanwhile, a federal appeals court in February ruled that the FCC had to review or eliminate some longstanding rules limiting ownership.

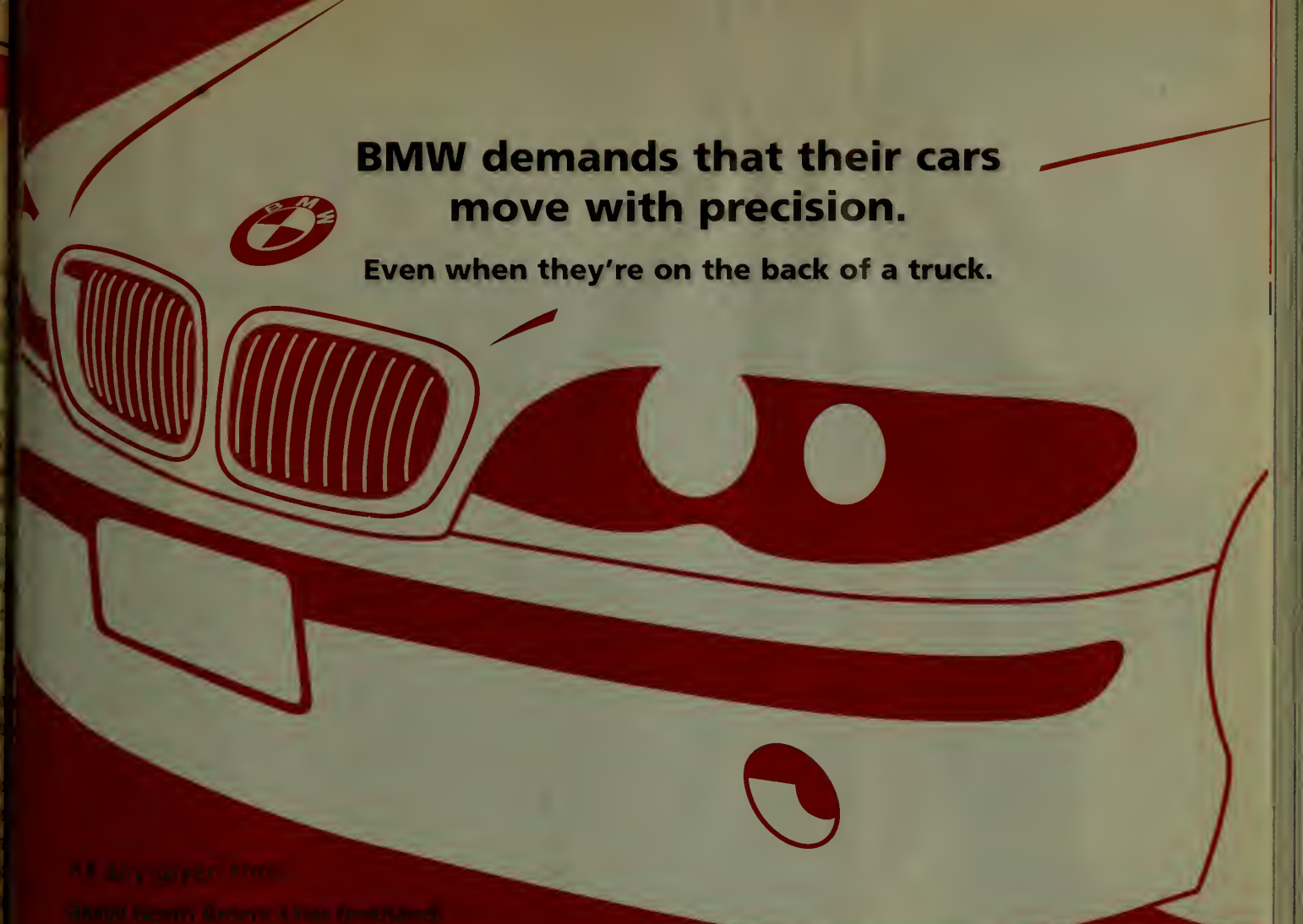
Powell argues that technological advances, including the Internet and cable TV, have created a multiplicity of new ways for Americans to get news and entertainment.

That makes existing limits on ownership less essential.

But while that argument makes sense in theory, in practice full-scale deregulation—which would likely lead to concentration in the media—would be a bad idea. Without limits, there will be a merger free-for-all in the media business. Companies that own big broadcast networks, such as Viacom Inc. and Walt Disney Co., could buy up more local TV stations. Cable companies would combine with networks. News companies would buy local TV stations in their cities.

The result will be that the number of independent voices would quickly diminish. Moreover, the troubles in financial markets could mean that it will be harder than ever to raise the money necessary to start up competing media companies.

Powell needs to focus on the value of maintaining diverse points of view in an information economy. One of the pillars of America's democracy and market economy is independent media with multiple voices. That's not something that should be tampered with.



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THE NEW AMERICAN AUTO INDUSTRY

Yes, Detroit is losing market share. But America is a big winner as foreign companies turn the U.S. into the center of a global industry. PAGE 98



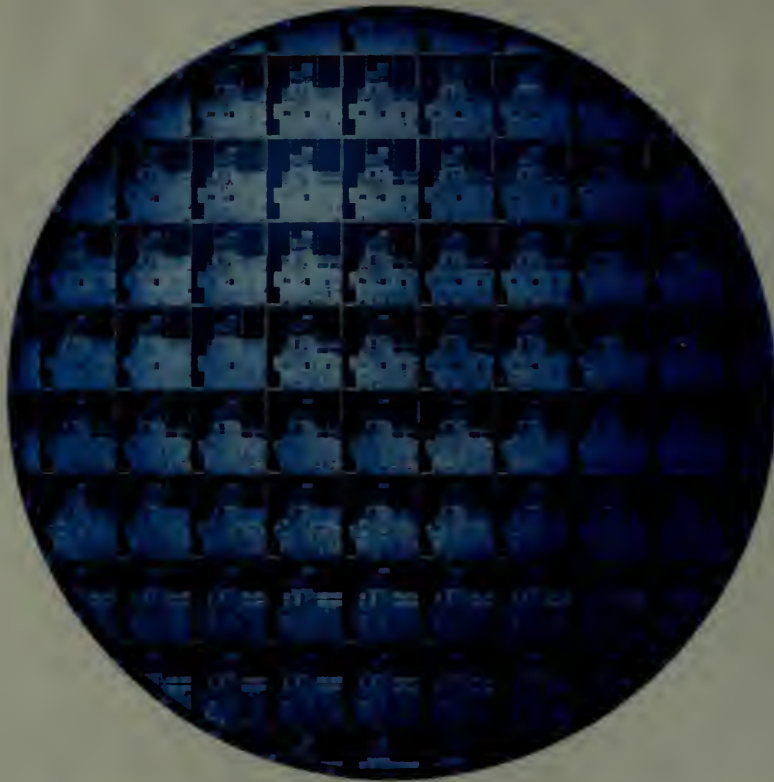
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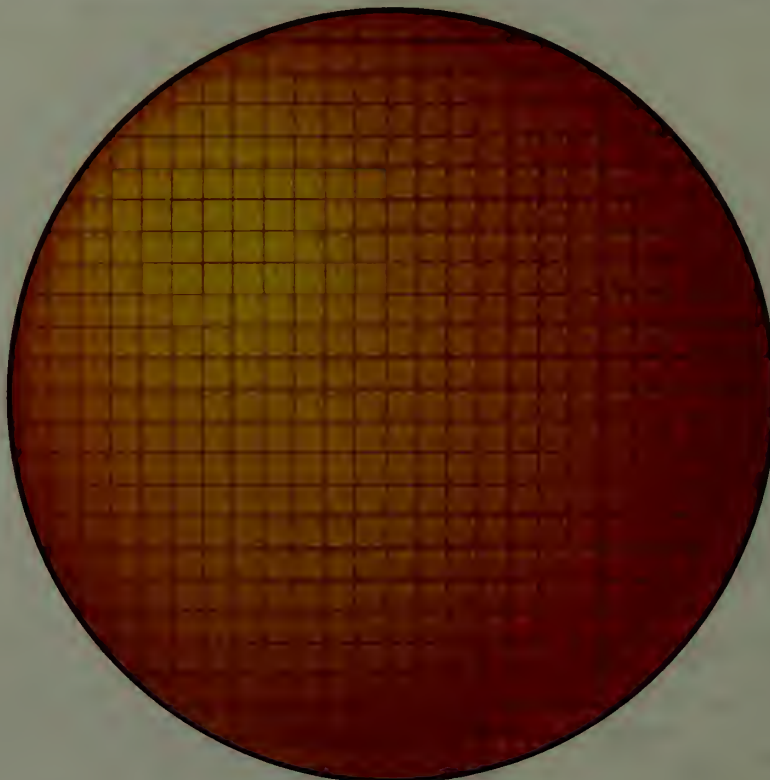
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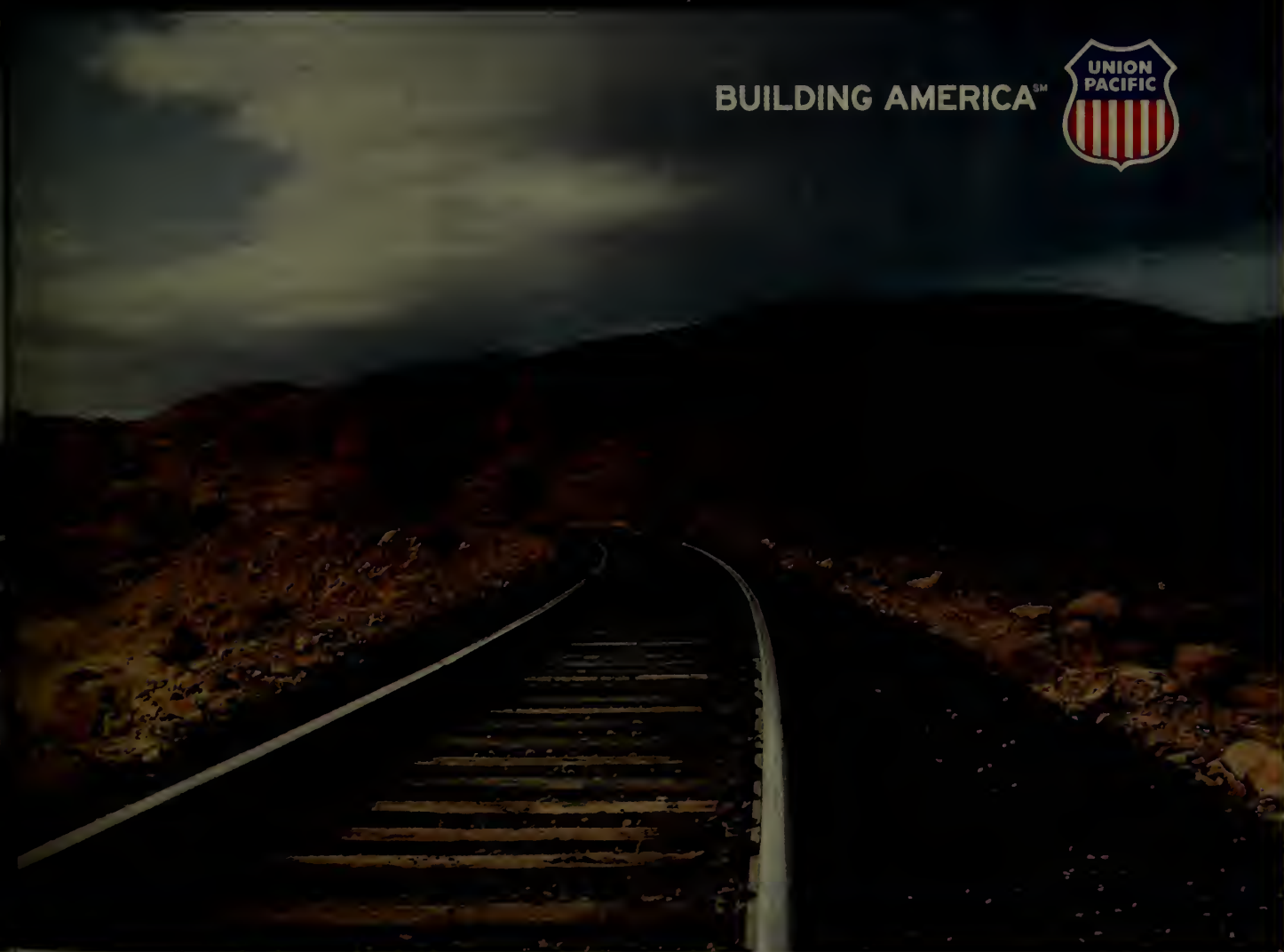
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MOVE OVER, MOTOWN

Foreign players are turning the U. S. into a global center for auto design and manufacturing

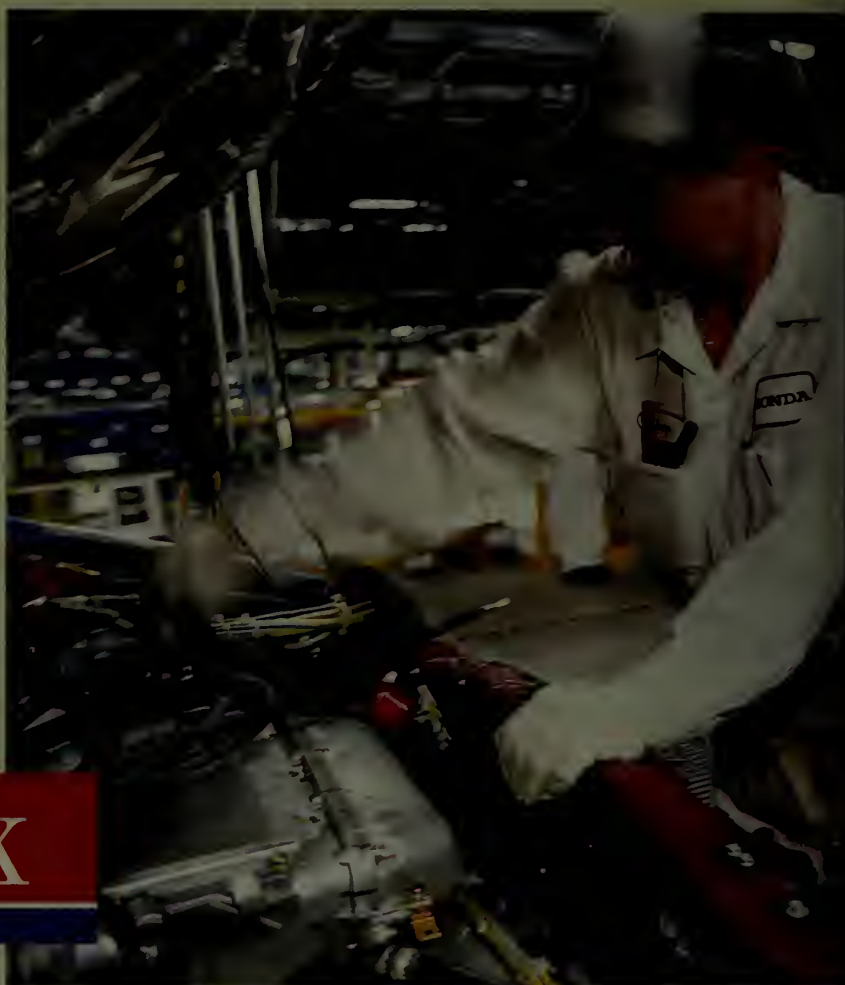
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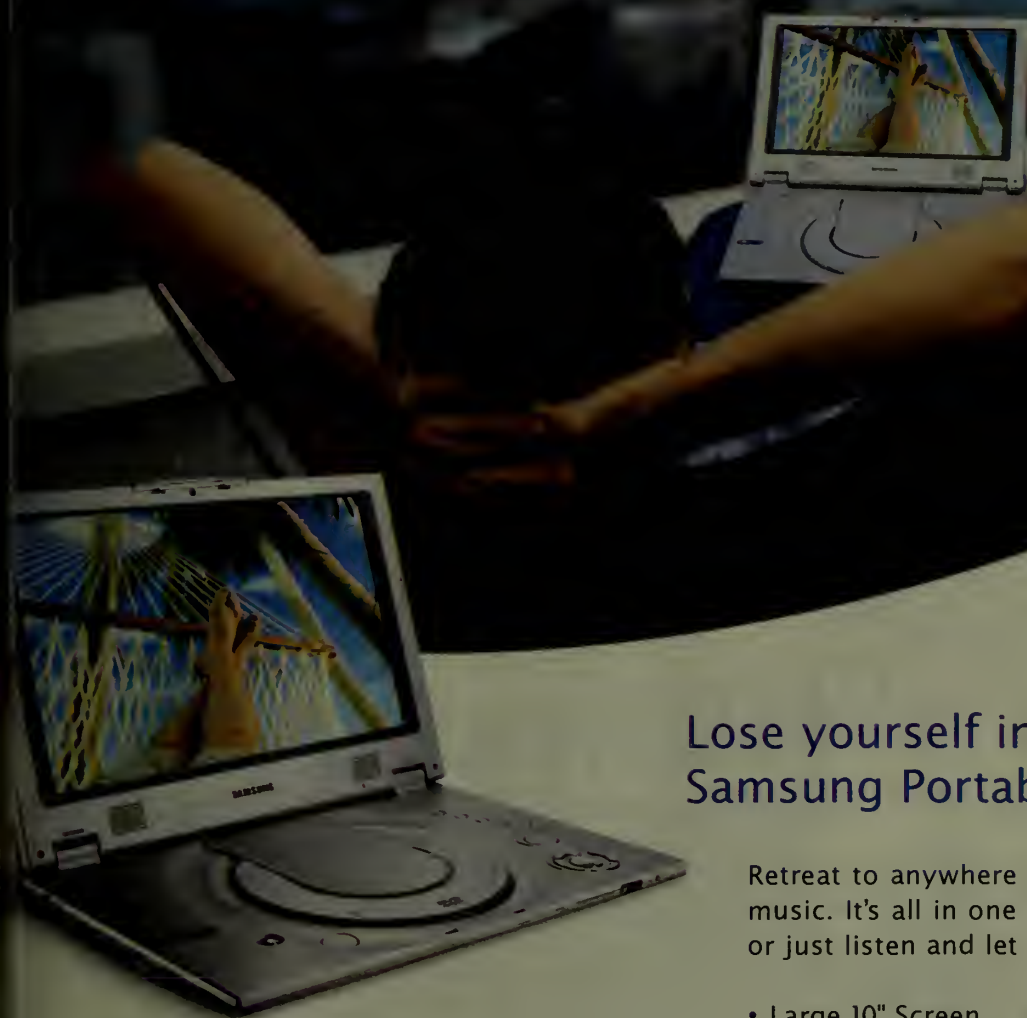
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Up Front

EDITED BY SHERIDAN PRASSO

AFTER 9/11

A DROUGHT OF FOREIGN TOURISTS

TERRORISTS MAY HAVE targeted New York and Washington, but now, almost 10 months after September 11, folks thousands of miles away are feeling the blow. Scared off by the possibility of another attack, the number of foreigners taking summer vacations in the U.S. has dropped precipitously. New York, Orlando, Las Vegas, and even Memphis are hurting.

Yet nowhere does the drop seem steeper than in America's big national parks. At the Grand Canyon, for instance, National Park Service officials estimate that at least 40% of the 5 million people who visit each year come from Japan, Germany, and

other countries. Not this summer. Visits by buses—a good way to gauge foreign tour groups—are running 35% below 2001 levels. Walk-ins to the visitors' center in Flagstaff, Ariz., have fallen to pre-1990 levels, and more than two dozen local shops and eateries have closed. "We're still feeling the impact of September 11," says Mary Bostwick, owner of the Arizona Mountain Inn in Flagstaff.

The Commerce Dept. reports that international travel to the U.S. plunged 11% in

TALK SHOW "Criminal charges may be too good for the people who brought about this mess."

—U.S. Securities & Exchange Commission Chairman Harvey Pitt, on the WorldCom fiasco



GRAND CANYON: Lonesome trails

2001, to 45.5 million visitors, and doesn't foresee a return to the record levels of 2000 until 2004. Then again, if the U.S. dollar keeps getting cheaper for foreigners, who knows?

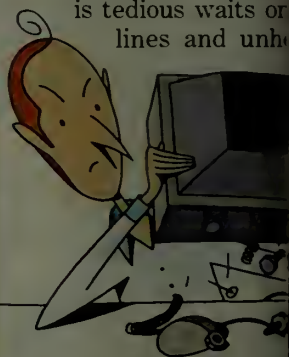
Michael Arndt

TECH TRAVAILS

NOT MUCH HELP FROM THE HELP LI

AFTER YEARS OF GI computer companies marks, consumers now hardware and software ers are falling down or job. Only 60% of 1,026 A icans polled by Harris I active in May said soft companies served custo well, down from 80% year; just 59% said hard companies did so, down 78%. Harris now ranks fifth and sixth in cons satisfaction—behind b hospitals, auto makers even airlines.

The industry has on self to blame. As sales fallen, PC companies hav tech-support staff. The is tedious waits or lines and unh



advice when people d through. Software, r while, is more complex. irksome issues: long 1 delays, botched shipn and rebates that neve rive, says Pete Blacksha chairman of customer Web site PlanetFeedba

For an industry desp for a rebound, this is bling. Dell Computer ha its PlanetFeedback gra to C- from B-. Gatewa a C, Intuit and Syma D+. Firms say they're to improve customer se but it's no easy task. "I isfaction is highly viral, Blackshaw. Sounds tech's Next Big Thing be getting back in b good graces. Andreu

ETHICS AND RELIGION

ON SECOND THOUGHT

WHEN IT COMES TO UNETHICAL behavior in Corporate America, does a CEO's religion matter? *The Wall Street Journal* thought so—then apparently changed its mind. On June 28, early editions of the paper ran a large table on 13 corporate leaders currently in hot water and included religious affiliations for eight. But later editions dropped any mention of religion.

Editors decided there were too many missing affiliations and that the information "didn't tell enough of a story to keep it in," says Melinda Beck, editor of the Marketplace section where the table appeared. There was no debate about whether religion plays a role in ethical behavior, she says, and the paper received no complaints.

Interestingly, five of the eight affiliations were Roman Catholic—a religion whose leaders have had their own share of controversy this year. Diane Brady

MARKETPLACE					
[THE WALL STREET JOURNAL]					
InClose	Samuel Waksal	54	Former CEO, from company's 19 founding until resigned in Ma	City, MBA	Divorced, Jewish
Martha Stewart Living Omnimedia	Martha Stewart	60	Chairman and executive, 19 present	College, BA	Divorced, Born Roman Catholic
Qwest Communications International	Joseph P. Nacchio	52	Former chairman and CEO, from until he resigned under pressure June 2002	University, BA and MBA, MIT, MS in	Married, Roman Catholic
Tyco International	L. Dennis Kozlowski	55	Former CEO, to June, 200	University, BA, MBA	Married, Roman Catholic
WorldCom	Bernard Ebbers	60	CEO, 1985 to	College,	Married, Baptist
WorldCom	Scott D. Sullivan	40	Former chief officer, 1994 to 2002	ofwego,	Married, Roman Catholic

Sources: WSJ research, Who's Who in America, the companies

Jon Runkle
Managing Director
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GOLDEN PARACHUTES

AT PHILIP MORRIS, PERKS FOR LIFE

WHEN GEOFFREY BIBLE retires from cigarette-and-food giant Philip Morris on Aug. 31, he will end a 15-year run at the top of one of the largest companies in the world. Although Bible will no longer be calling the shots, he'll still be free to call up the corporate jet. According to his exit agreement, filed with the Securities & Exchange Commission, Philip Morris will pro-

BIBLE: *Sweet exit deal*

vide its onetime leader with the following benefits, in exchange for occasionally being available as a consultant, for

as long as he lives:

- an office near his home, including a secretary
- an unlimited phone-calling card
- two cell phones and two fax machines, plus the cost of maintenance
- security at his home and at his vacation home
- access to the corporate plane, dining room, and gym
- a company car and driver or a car allowance of up to \$100,000 a year
- up to \$15,000 a year for financial-advisory services.

While it seems amazing that a man who earned \$50 million in salary, bonus, and other compensation in 2001 could need all this, executive-pay experts say this isn't unheard of.

Such exit packages started cropping up in the mid-1990s, says Judy Fischer, managing director of Executive Compensation Advisory Services, though Bible's appears extremely generous. "If I were a shareholder, I would raise my eyebrow at this continuing outlay of corporate expenses that are really quite pricey just to take care of someone in retirement," she says.

A Philip Morris spokeswoman says Bible's package is comparable to other executives and that the company did thorough research before settling on the details. Such perks, she says, are "standard operating procedure."

Nanette Byrnes

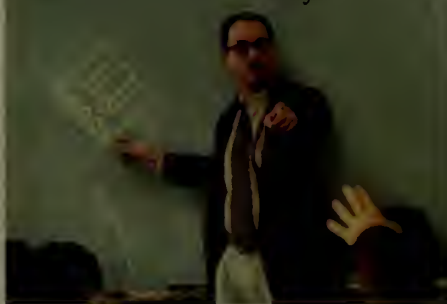
SCANDAL SHEET

ENRON 101

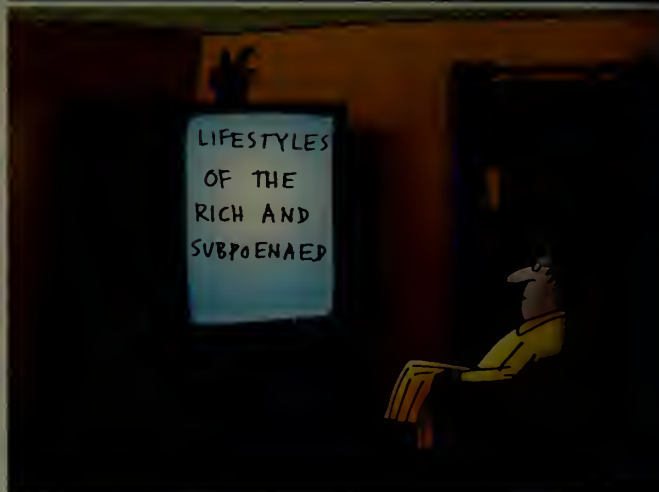
JUST ADDED TO THE FALL curriculum and already oversubscribed: "The Enron Case," a five-week course at the University of California at Irvine's Graduate School of Management. A maximum capacity of 55 MBA students (15 more than the classroom normally holds) will study the biggest corporate bankruptcy in U.S. history from its start to its tragic end.

They'll listen to guest speakers, including accountants, a federal prosecutor, a newspaper reporter, and an economist. Enron whistleblower Sherron Watkins is lined up to speak, too.

Professor Richard McKenzie says he wants students to "set aside what they've heard and read and look at the financials and statements and issues from the beginning." One question: Is there extra credit for not cheating on the homework? *Jennifer Merritt*



DRAWN & QUARTERED



GREEN WATCH

A NUKE-TRANSPORT ROUTE NEAR YOU

SCORE ONE FOR THE GREENS. A July 27 deadline is drawing near for a Senate vote on setting up a repository for 45,000 tons of nuclear waste at Yucca Mountain in Nevada. So the grassroots Environmental Working Group has found a way to show how the risks hit home.

Its Web site maps how close people's houses are to expected nuclear-waste transportation routes, which will go from the nation's 103 nuclear power plants to Yucca Mountain (www.MapScience.org). Map-

ping the Chicago Mercantile Exchange, for example, shows a nuclear route 1.4 miles away. The non-profit says it has had requests to generate maps every five days since its June 11 launch. The hope is that concerned citizens will urge their

tors to vote on the plan.

Naturally, the industry is furious. The Nuclear Energy Institute says the map is misleading, cause transportation routes are final. The NEI says the U.S. safely ships clear waste

times since 1964. Capitol sources say Yucca is likely to be approved anyway, but the lesson is clear: Politics never sleeps. *Laura*

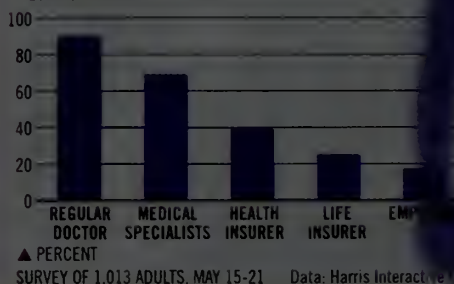


PROTEST: *New map*

THE BIG PICTURE

DNA DISCLOSURE

Most people don't want even their health insurers to know the results of genetic testing that can predict predisposition to disease. Here's who they think should have access to results:



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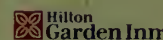
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OUTRAGE THAT DEMANDS ACTION

As we say in "Restoring trust in Corporate America" (Cover Story, June 24), rarely have business and its leaders been held in such low esteem. Yet most of the business community has been silent, even as the crisis becomes dangerously disruptive for the market and the economy. Here, readers respond to the cover story and editorial, "Rebuilding trust—before it's too late."

THE OBSCENITY OF CEO PAY

Your recent editorials lambasting Corporate America for its lack of oversight, greed, and outright wrongdoing are excellent, timely, and desperately needed ("Corporate governance: The road back," May 6, and "Rebuilding trust—before it's too late," June 24). *BusinessWeek* has rallied for years against the growing obscenity of executive pay packages, yet the gap between CEO and worker pay (currently at 600:1) continues to grow. I am at a loss as to how those in the boardroom who have even the slightest comprehension of trust, honor, and fairness can approve such pay packages and not see the damage that such excess inflicts throughout the employee ranks. This inequity leads to an erosion of confidence that further erodes the commitment to performance, as employees see the rewards of that performance lavishly showered on those at the top.

Please continue to speak out. Let's hope someone will hear the message.

Peter Grazier
 Chadds Ford, Pa.

SING OUT, STRAIGHT-SHOOTERS

For every Enron Corp., there is a Warren E. Buffett. For every Andersen, there is a James F. [CEO of Southwest Airlines]. For every huckster CEO, there are hundreds of dedicated, honest CEOs. Only when these executives begin to speak out will they begin to change the culture for the better. An alliance of these leaders will do more to restore corporate confidence than all the effects of governmental controls, indignation, and shareholder dissatisfaction combined.

Roland Carmo



'THERE IS NO SHARE LEFT'

Restoration of trust in Corporate America, which is forthcoming. The first step needed is a statement similar to that of Herb Paulson Jr.'s from de

no, hundreds—of other leaders. For example, is Jeffrey R. Immelt heir to the man the business press has named Saint Jack? The silence of General Electric Co. is deafening.

Neither Mr. Immelt nor most CEOs dare say anything because it is well known to reporters both in the business and political that the big-gun lobbyists for Corporate America are paid overtime to make sure there will be no effective legislation on corporate governance or accounting. A CEO needs support for reform would be haggard

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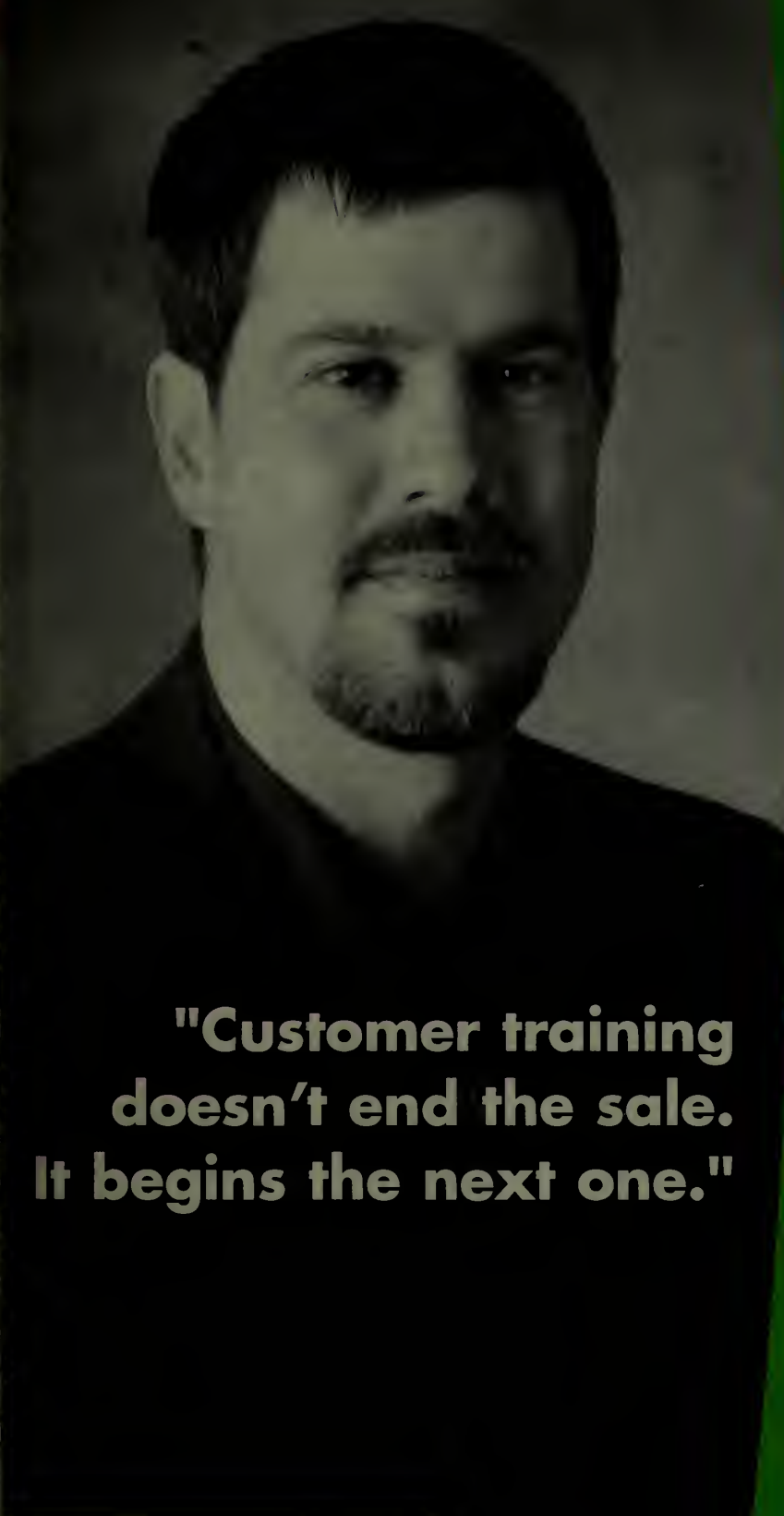
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Jim Mannarino

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Readers Report

CORRECTIONS & CLARIFICATIONS

Because of a production error, the table "BusinessWeek's Midyear Economic Forecast Survey for 2002-03" (BusinessWeek Investor, July 1) was mislabeled. The eighth and ninth columns of numbers were projections for the federal funds rate at the end of the fourth quarter, 2002, and second quarter, 2003 respectively. The last column contained projections of the month for the first Fed rate hike.

"Sprint's sprightly marketing push" (Up Front, July 1) incorrectly stated that Samsung Group and others will make phones loaded with music and games for the Virgin-Sprint wireless service. Kyocera Wireless Corp. is Virgin Mobile USA's exclusive cell-phone provider.

reporters on the petard of his/her Washington lobbyists.

The fact that there is no shame left in the corporate-political culture is demonstrated by the U.S. Senator who is carrying most of the water for the anti-reform movement, Phil Gramm (R-Tex.). His wife was on Enron's board, for Pete's sake! Nevertheless, he works diligently to pull the teeth of any proposed reform.

Serious reform? Yeah, sure.

James E. Waters
Wilmington, N.C.

THE CEO'S TEAM: NO 'YES MEN'

The good leaders I have had the opportunity to work with over some 30 years were fully aware of the dangers of the CEO role: a false sense of self-importance, arrogance, entitlement, and the ability to influence their personal economic gain.

What those of character did was quite simple: They surrounded themselves with expert and independent people and required them to challenge any action that put the CEO's interests before those of shareholders, customers, and employees. Envision a "team of three" consisting of the chief financial, legal, and human-resources officers working together and individually to insure that the CEO does the right thing!

The CEO defines the way business is conducted and selects his/her team. Take a look at that team, and you will get a good read on the quality of the leader and the way the business is managed.

John Potempa
Hinsdale, Ill.

CRONYISM, AMERICAN-STYLE

What has finally surfaced is the pervasive conceitedness of the ol' boy network—now commanded by a less competent generation. American businesses are starting to show signs of too much cronyism based on college, union, neighborhood, and ethnic background, while ignoring the merits of the unassociated outsider. [They] think this is the jet set, credit card, hula hoop, WASPish 1950s.

Todd Parham
Pittsburgh

BLINDED BY SALARY BLOAT

Has Corporate America so lost its perspective and sense of responsibilities that it shoots itself in the foot and doesn't even bother to limp? Apparently, these execs are too afraid of somehow jeopardizing their bloated salaries. *BusinessWeek*, good for you and Goldman Sachs & Co.'s Hank Paulson for taking the courageous and forthright stance in pointing out what obviously and necessarily should be done.

R.D. Higgins
San Diego

MAKE BUSINESS, NOT WAR

Most business requires only that an organization obtain supplies, add value, and resell. It's that simple. But execs who have not quite mentally left the sandbox read Machiavelli and Sun-tzu for business lessons and "deploy" a sales "force" of "road warriors," thump chests at meetings, and with greater solemnity than any gladiator who entered the Colosseum mutually pledge to do "whatever it takes." All might be fair in love and war, but business is neither. If we want to restore trust in Corporate America, let's have the business press turn down the rhetorical volume to a level that makes it impossible to confuse day-to-day work with blood sports.

Perry Glasser
Haverhill, Mass.

STRAIGHT TALK BEATS SPIN

I've created corporate, investor-relations, and marketing communications for 40 years, and I've met few execs who were able to resist the temptation to add a little gloss to their messages ("spin"), which then reinforces the view that businesses can't be trusted.

As long as its leaders equate selling with hyping, Corporate America will never be trusted. What makes this doubly sad is that it's not necessary. If ex-

ecs could forego euphemisms and talk straight, adult-to-adult, they'd begin to earn constituents' trust. I have a compelling story to tell, and the truth does have a ring to it—especially when people expect to be misled.

David
Mill Valley,

THE BEST MESSAGE IS JAIL

All ill-gotten gains made by the executives in recent months should be turned to the corporation and red-empted to the hard-working employees and other stock owners. These execs should not profit one bit from their greedy actions. In fact, many of them should go to jail.

Thank God for people such as York Attorney General Eliot Spitzer who hope he goes after all the wrongs and punishes them as they deserve.

Leo E. Fom
Camarillo,

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THE VICTIM'S FORTUNE

Inside the Epic Battle over the Debts of the Holocaust

By John Authers and Richard Wolffe

HarperCollins • 458pp • \$29.95

A FLAWED CRUSADE FOR HOLOCAUST JUSTICE

Fifty years after the end of World War II, a small group of American Jews launched a campaign to resolve one of the most complex issues of the Holocaust: the plundering of the property of European Jewry by the Nazis and their accomplices. In time, the aggrieved would win some monetary redress and a good deal of publicity for their cause. But as John Authers and Richard Wolffe show in *The Victim's Fortune*, what began as a crusade for justice led quickly, and perhaps inevitably, to an unseemly squabble over money and representation. The authors, both of the *Financial Times*, have provided a well-written account of a fascinating, convoluted set of events.

In 1952, the fledgling government of Israel signed a reparations agreement that provided for large payments by the West German government over many years. Along with the Jewish state, concentration camp inmates received compensation, as did individuals who had lost assets and their livelihoods in Germany. These payments ran into tens of billions of dollars, but they did not cover property lost outside of Germany or restitution for slave labor.

In the decades that followed, there was little discussion of the Nazis' systematic looting of the Jews. In the thousands of pages written about the Holocaust, the matter was largely ignored. Partly, this was a result of the Cold War, which pushed unresolved issues of earlier decades to the margins. Also, Jewish organizations did not want the world to think they were trying to capitalize on one of the 20th century's greatest human tragedies. Some Jewish victims even refused to take what they saw as blood money and a German attempt to buy forgiveness.

Still, Germany at least had confronted the issue. Eastern European countries such as Poland and Hungary, which had

the largest prewar Jewish populations in Europe, are only today getting around to the task of returning Jewish assets, the better part of which were appropriated by communist regimes. Reparations efforts in Western European countries also idled for years. Norway, which had a tiny Jewish population and thus little liability, did not get around to returning all stolen assets until 1997. France and Holland, which had much larger Jewish communities, returned some property immediately after the war but did little to help families of murdered Jews retrieve plundered assets.

The Swiss, with their famously secretive bankers, may have been the least forthcoming. *The Victim's Fortune* begins with them. Authers and Wolffe excel in describing the effort of the World Jewish Congress, a battalion of class-action lawyers, and numerous politicians, including former U.S. Senator Alfonse D'Amato and New York City Comptroller Alan Hevesi, to force Swiss banks to settle the issue of accounts that had lain dormant since the war.

WJC Secretary-General Israel Singer started confronting the Swiss banks in 1995. The contest became a very personal one for Singer, who felt the urgency of resolving matters before all of the Holocaust survivors died. Singer became a master at using the media and politicians to keep the issue before the public. But he could not have mounted much of an assault without the backing of WJC President Edgar Bronfman, the billionaire former Seagram Co. CEO and political donor. Bronfman provided the political entrée to the Clinton White House that led to a deep Administration involvement. Before long, the Clinton

Administration had its own point man, Stuart Eizenstat, Under Secretary of State and later Deputy Treasury Secretary. Facing such opponents—and a threat of sanctions by Hevesi, who saw New York City's borrowing as a threat to pension funds—the Swiss banks agreed to a \$1.25 billion settlement in the courts matter.

As the struggle shifted to France, Germany, and Austria, even more action lawyers jumped on board, though some had noble reasons for entering the fight, in *The Victim's Fortune*, even the best-intentioned across as opportunists. Nor do the Jewish organizations, which demanded control over unclaimed funds, fare better. But without them—and Jews who forced the parties to compromise—it is doubtful that giant European corporations and governments would have acted. In late 1999, fearful of being dragged into unfriendly U.S. courts, such industrial giants as Dai

Chrysler, Volkswagen, Siemens, and Krupp agreed to a payout of \$5 billion to compensate slave labor.

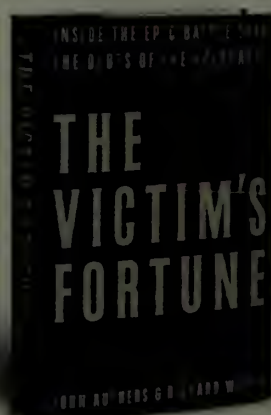
Ironically, the Holocaust survivors felt little sense of success experienced by those more directly involved in the negotiations. Some, such as Clara Weiss, the lead plaintiff against the Swiss banks, came critics of the process. By the time of the settlement, her son

her lawyer and Singer, both of whom she saw as unresponsive, seemed to her disgust for the banks. Clara, such as Martin Stern, the grandson of a Holocaust victim, focused their Jewish groups, particularly the Stern carried on a battle against Assicurazioni Generali, the giant Italian insurance company accused of failing to pay Jewish prewar policyholders.

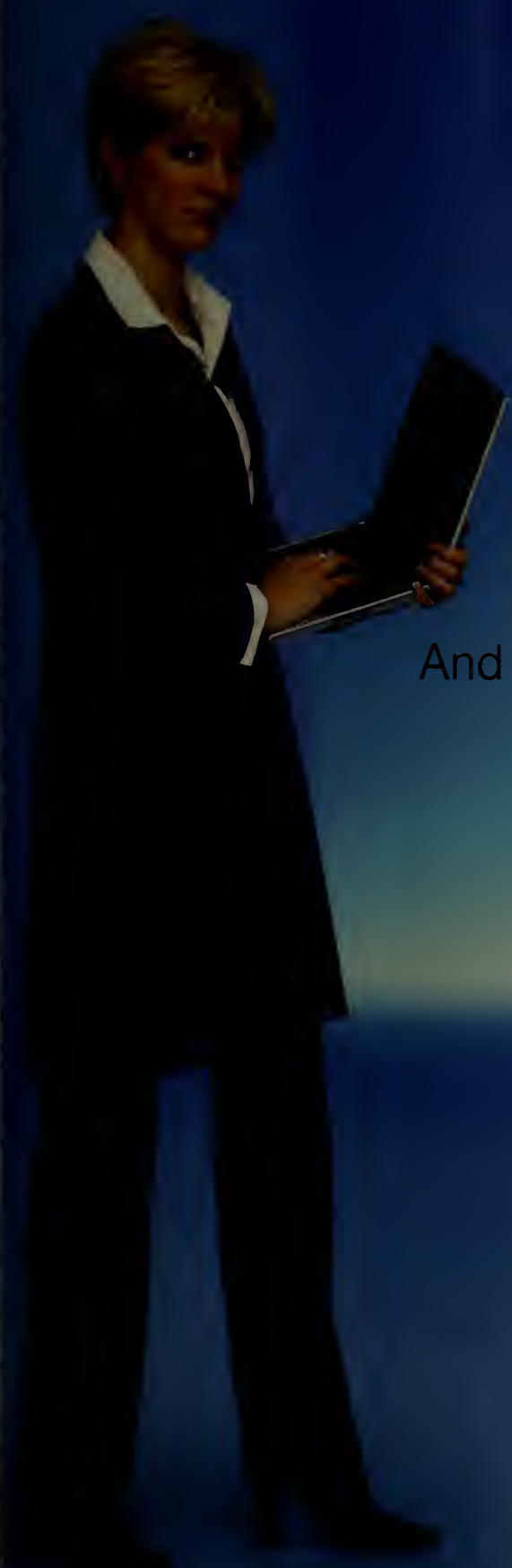
But the reaction of 71-year-old Ruth Rothman, after receiving his check for years of slave labor, was only more typical. "The point is the same," he said. "Too little, too late. But if it had been earlier or later, it would have been no more moral."

BY NEAL SA

Jerusalem correspondent Sanda Simionescu has extensively covered the Swiss bank



BILLIONAIRE BRONFMAN WAS KEY TO DRAWING THE CLINTON ADMINISTRATION INTO THE BATTLE



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The BusinessWeek Best-Seller List

HARDCOVER BUSINESS BOOKS			LAST MONTH	MONTHS ON LIST	PAPERBACK BUSINESS BOOKS			LAST MONTH
1	WHO MOVED MY CHEESE? Spencer Johnson (Putnam • \$19.95) <i>Learning to accept change.</i>	1	41	1	RICH DAD, POOR DAD Robert T. Kiyosaki, with Sharon L. Lechter (Warner • \$15.95) <i>Teach your kids the rules of money that the rich play by.</i>	1		
2	GOOD TO GREAT Jim Collins (HarperBusiness • \$27.50) <i>How run-of-the-mill companies make the leap to excellence.</i>	2	8	2	FAST FOOD NATION Eric Schlosser (HarperCollins • \$13.95) <i>The bad news on burgers.</i>	2		
3	FISH! Stephen C. Lundin, Harry Paul, John Christensen (Hyperion • \$19.95) <i>Motivate employees the Pike Place Fish Market way.</i>	3	21	3	THE 7 HABITS OF HIGHLY EFFECTIVE PEOPLE Stephen R. Covey (Fireside • \$14) <i>Habitually popular.</i>	4		
4	MARTHA INC. Christopher M. Byron (Wiley • \$27.95) <i>Behind the domestic diva's mystique.</i>	5	2	4	A BEAUTIFUL MIND Sylvia Nasar (Touchstone • \$16) <i>The real John Forbes Nash Jr.</i>	3		
5	NOW, DISCOVER YOUR STRENGTHS Marcus Buckingham, Donald O. Clifton (Free Press • \$27) <i>How to bolster your true talents.</i>	10	17	5	THE TIPPING POINT Malcolm Gladwell (Back Bay • \$14.95) <i>What turns an idea into a hot trend.</i>	6		
6	FIRST, BREAK ALL THE RULES Marcus Buckingham, Curt Coffman (Simon & Schuster • \$27) <i>A Gallup probe into managerial success.</i>	7	37	6	KITCHEN CONFIDENTIAL Anthony Bourdain (Ecco • \$14) <i>A peek inside the restaurant industry, by a veteran chef.</i>	7		
7	PRIMAL LEADERSHIP Daniel Goleman, Richard Boyatzis, Annie McKee (Harvard Business School • \$26.95) <i>Using "emotional intelligence" as a leadership tool.</i>	6	4	7	RICH DAD'S RETIRE YOUNG RETIRE RICH Robert T. Kiyosaki, with Sharon L. Lechter (Warner • \$17.95) <i>Plan ahead.</i>	5		
8	FISH! TALES Stephen C. Lundin, John Christensen, Harry Paul, with Philip Strand (Hyperion • \$19.95) <i>Reel in more of the "Fish! Philosophy."</i>	9	2	8	WHAT COLOR IS YOUR PARACHUTE? Richard Nelson Bolles (Ten Speed • \$16.95) <i>The 2002 edition of the enduring job-search bible.</i>	11		
9	JACK Jack Welch, with John A. Byrne (Warner Business • \$29.95) <i>GE's ex-chairman reflects on his life and accomplishments.</i>	8	9	9	RICH DAD'S CASHFLOW QUADRANT Robert T. Kiyosaki, with Sharon L. Lechter (Warner • \$17.95) <i>Move from job security to financial independence.</i>	8		
10	THE FIVE DYSFUNCTIONS OF A TEAM Patrick Lencioni (Jossey-Bass • \$22) <i>Overcoming behavior that obstructs teamwork.</i>	--	1	10	REAL ESTATE RICHES Dolf De Roos (Warner • \$17.95) <i>Why buildings are better investments than stocks.</i>	10		
11	CONFESSIONS OF A STREET ADDICT James J. Cramer (Simon & Schuster • \$26) <i>The former hedge-fund manager's memoir.</i>	--	1	11	THE ONE MINUTE MANAGER Kenneth Blanchard, Spencer Johnson (Berkley • \$12.95) <i>Management techniques in story form.</i>	12		
12	WHALE DONE! Ken Blanchard, Thad Lacinak, Chuck Tompkins, Jim Ballard (Free Press • \$19.95) <i>Tips from Shamu's trainers.</i>	11	3	12	GETTING TO YES Roger Fisher, William Ury, Bruce Patton (Penguin • \$14) <i>A Harvard team's step-by-step guide to conflict resolution.</i>	9		
13	THE 21 IRREFUTABLE LAWS OF LEADERSHIP John C. Maxwell (Thomas Nelson • \$22.99) <i>A minister's down-to-earth rules.</i>	13	20	13	THE MILLIONAIRE NEXT DOOR Thomas J. Stanley, William D. Danko (Pocket Books • \$7.99) <i>The simple ways of the wealthy among us.</i>	--		
14	THE RUMSFELD WAY Jeffrey A. Krames (McGraw-Hill • \$18.95) <i>How the Defense Secretary does it.</i>	--	1	14	RICH DAD'S GUIDE TO INVESTING Robert T. Kiyosaki, with Sharon L. Lechter (Warner • \$19.95) <i>Becoming rich, not merely comfortable.</i>	13		
15	RAVING FANS Ken Blanchard, Sheldon Bowles (Morrow • \$20) <i>Turning customers into your biggest boosters.</i>	14	43	15	BUILT TO LAST James C. Collins, Jerry I. Porras (HarperBusiness • \$17) <i>How 3M, Wal-Mart, and others became standouts.</i>	--		

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Reviews and more are available on AOL (Keyword: BW) or www.businessweek.com

HOT TYPE

WORK, FOR THE MOST PART, ISN'T FUN. After all, when Adam got kicked out of the Garden of Eden and ordered to "till the ground," it was meant as a punishment. But the authors of *Fish! Tales*, this month's No. 8 hardback, say drudgery isn't inevitable. Key to what they call the "Fish! Philosophy" is the idea that on-the-job play increases workforce commitment and creativity.

The book describes several rejuvenated workplaces, many of them at high-stress, modest-pay companies. In each instance,

unconventional behavior is celebrated: A Sprint manager personates Elvis to perk up his customer-service agents, a stance, or a nurse's assistant plays his clarinet to a patient. In the end, everyone feels better and is more productive. *Fish! Tales* also suggests adopting a positive attitude and being kind.

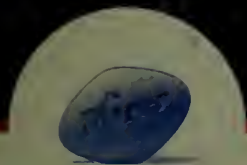
Is that all it takes to improve work? Put it this way: expect your office to turn into the Garden of Eden.

BY HARDY

I TAKE BATTING PRACTICE | Over 450 home runs

I TAKE INFIELD PRACTICE | 3 Gold Gloves

I TAKE VIAGRA | Let's just say it works for me



Rafael Palmeiro, VIAGRA has some impressive stats. In 4 years, more than 1 million prescriptions have been written in the United States alone. Plus, VIAGRA has helped more than 13 million men worldwide rediscover their love lives. Hey, it all adds up to what Rafael did. Ask your doctor if a free sample of VIAGRA is right for you.

VIAGRA[®]
(sildenafil citrate) tablets



For more information, visit www.viagra.com

Please see patient summary of information for VIAGRA (25-mg, 50-mg, 100-mg) tablets on the following page.

is indicated for the treatment of erectile dysfunction. Remember that no medicine is for everyone. If you use nitrate drugs (often used to control chest pain (angina)), don't take VIAGRA. This combination could cause your blood pressure to drop to an unsafe or life-threatening level. Discuss your general health status with your doctor to ensure that you are healthy enough to engage in sexual activity. If you experience chest pain, nausea, or any other discomforts during sex or an erection longer than 4 hours, seek immediate medical help. The most common side effects of VIAGRA are headache, facial flushing, and upset stomach. Less commonly, dizziness, blurred vision, or sensitivity to light may briefly occur.



PATIENT SUMMARY OF INFORMATION ABOUT

VIAGRA[®]
 (sildenafil citrate) tablets
This summary contains important information about

VIAGRA. It is not meant to take the place of your doctor's instructions. Read this information carefully before you start taking VIAGRA. Ask your doctor or pharmacist if you do not understand any of this information or if you want to know more about VIAGRA.

This medicine can help many men when it is used as prescribed by their doctors. However, VIAGRA is not for everyone. It is intended for use only by men who have a condition called erectile dysfunction.

VIAGRA must never be used by men who are taking medicines that contain nitrates of any kind, at any time. This includes nitroglycerin. If you take VIAGRA with any nitrate medicine your blood pressure could suddenly drop to an unsafe or life threatening level.

What is VIAGRA?

VIAGRA is a pill used to treat erectile dysfunction (impotence) in men. It can help many men who have erectile dysfunction get and keep an erection when they become sexually excited (stimulated).

You will not get an erection just by taking this medicine. VIAGRA helps a man with erectile dysfunction get an erection only when he is sexually excited.

How Sex Affects the Body

When a man is sexually excited, the penis rapidly fills with more blood than usual. The penis then expands and hardens. This is called an erection. After the man is done having sex, this extra blood flows out of the penis back into the body. The erection goes away. If an erection lasts for a long time (more than 6 hours), it can permanently damage your penis. You should call a doctor immediately if you ever have a prolonged erection that lasts more than 4 hours.

Some conditions and medicines interfere with this natural erection process. The penis cannot fill with enough blood. The man cannot have an erection. This is called erectile dysfunction if it becomes a frequent problem.

During sex, your heart works harder. Therefore sexual activity may not be advisable for people who have heart problems. Before you start any treatment for erectile dysfunction, ask your doctor if your heart is healthy enough to handle the extra strain of having sex. If you have chest pains, dizziness or nausea during sex, stop having sex and immediately tell your doctor you have had this problem.

How VIAGRA Works

VIAGRA enables many men with erectile dysfunction to respond to sexual stimulation. When a man is sexually excited, VIAGRA helps the penis fill with enough blood to cause an erection. After sex is over, the erection goes away.

VIAGRA Is Not for Everyone

As noted above (*How Sex Affects the Body*), ask your doctor if your heart is healthy enough for sexual activity.

If you take any medicines that contain nitrates—either regularly or as needed—you should never take VIAGRA.

If you take VIAGRA with any nitrate medicine or recreational drug containing nitrates, your blood pressure could suddenly drop to an unsafe level. You could get dizzy, faint, or even have a heart attack or stroke. Nitrates are found in many prescription medicines that are used to treat angina (chest pain due to heart disease) such as:

- nitroglycerin (sprays, ointments, skin patches or pastes, and tablets that are swallowed or dissolved in the mouth)
- isosorbide mononitrate and isosorbide dinitrate (tablets that are swallowed, chewed, or dissolved in the mouth)

Nitrates are also found in recreational drugs such as amyl nitrate or nitrite ("poppers"). If you are not sure if any of your medicines contain nitrates, or if you do not understand what nitrates are, ask your doctor or pharmacist.

VIAGRA is only for patients with erectile dysfunction. VIAGRA is not for newborns, children or women. Do not let anyone else take your VIAGRA. VIAGRA must be used only under a doctor's supervision.

What VIAGRA Does Not Do

- VIAGRA does not cure erectile dysfunction. It is a treatment for erectile dysfunction.
- VIAGRA does not protect you or your partner from getting sexually transmitted diseases, including HIV—the virus that causes AIDS.
- VIAGRA is not a hormone or an aphrodisiac.

What To Tell Your Doctor Before You Begin VIAGRA

Only your doctor can decide if VIAGRA is right for you. VIAGRA can cause mild, temporary lowering of your blood pressure. You will need to have a thorough medical exam to diagnose your erectile dysfunction and to find out if you can safely take VIAGRA alone or with your other medicines. Your doctor should determine if your heart is healthy enough to handle the extra strain of having sex.

Be sure to tell your doctor if you

- have ever had any heart problems (e.g., angina, chest pain, heart failure, irregular heart beats, or heart attack)

- have ever had a stroke
- have low or high blood pressure
- have a rare inherited eye disease called retinitis pigmentosa
- have ever had any kidney problems
- have ever had any liver problems
- have ever had any blood problems, including sickle cell anemia or leukemia
- are allergic to sildenafil or any of the other ingredients of VIAGRA tablets
- have a deformed penis, Peyronie's disease, or ever had an erection that lasted more than 4 hours
- have stomach ulcers or any types of bleeding problems
- are taking any other medicines

VIAGRA and Other Medicines

Some medicines can change the way VIAGRA works. Tell your doctor about **any medicines** you are taking. Do not start or stop taking any medicines before checking with your doctor or pharmacist. This includes prescription and nonprescription medicines or remedies. Remember, VIAGRA should never be used with medicines that contain nitrates (see *VIAGRA Is Not for Everyone*). If you are taking a protease inhibitor, your dose may be adjusted (please see *Finding the Right Dose for You*). VIAGRA should not be used with any other medical treatments that cause erections. These treatments include pills, medicines that are injected or inserted into the penis, implants or vacuum pumps.

Finding the Right Dose for You

VIAGRA comes in different doses (25 mg, 50 mg and 100 mg). If you do not get the results you expect, talk with your doctor. You and your doctor can determine the dose that works best for you.

- Do not take more VIAGRA than your doctor prescribes.
- If you think you need a larger dose of VIAGRA, check with your doctor.
- VIAGRA should not be taken more than once a day.

If you are older than age 65, or have serious liver or kidney problems, your doctor may start you at the lowest dose (25 mg) of VIAGRA. If you are taking protease inhibitors, such as for the treatment of HIV, your doctor may recommend a 25 mg dose and may limit you to a maximum single dose of 25 mg of VIAGRA in a 48 hour period.

How To Take VIAGRA

Take VIAGRA about one hour before you plan to have sex. Beginning in about 30 minutes and for up to 4 hours, VIAGRA can help you get an erection if you are sexually excited. If you take VIAGRA after a high-fat meal (such as a cheeseburger and french fries), the medicine may take a little longer to start working. VIAGRA can help you get an erection when you are sexually excited. You will not get an erection just by taking the pill.

Possible Side Effects

Like all medicines, VIAGRA can cause some side effects. These effects are usually mild to moderate and usually don't last longer than a few hours. Some of these side effects are more likely to occur with higher doses. The most common side effects of VIAGRA are headache, flushing of the face, and upset stomach. Less common side effects that may occur are temporary changes in color vision (such as trouble telling the difference between blue and green objects or having a blue color tinge to them), eyes being more sensitive to light, or blurred vision.

In rare instances, men have reported an erection that lasts many hours. You should call a doctor immediately if you ever have an erection that lasts more than 4 hours. If not treated right away, permanent damage to your penis could occur (see *How Sex Affects the Body*).

Heart attack, stroke, irregular heart beats, and death have been reported rarely in men taking VIAGRA. Most, but not all, of these men had heart problems before taking this medicine. It is not possible to determine whether these events were directly related to VIAGRA.

VIAGRA may cause other side effects besides those listed on this sheet. If you want more information or develop any side effects or symptoms you are concerned about, call your doctor.

Accidental Overdose

In case of accidental overdose, call your doctor right away.

Storing VIAGRA

Keep VIAGRA out of the reach of children. Keep VIAGRA in its original container. Store at room temperature, 59°-86°F (15°-30°C).

For More Information on VIAGRA

VIAGRA is a prescription medicine used to treat erectile dysfunction. Only your doctor can decide if it is right for you. This sheet is only a summary. If you have any questions or want more information about VIAGRA, talk with your doctor or pharmacist, visit www.viagra.com or call 1-888-4VIAGRA.

Rev. 4, June 1999

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STEPHEN H. WILDSTROM

you@businessweek.com

XP'S UPDATE WORTH A DOWNLOAD?



It will be more important for computer makers and users of new computers

More than four years after it was filed, the government's antitrust case against Microsoft is finally about to bear fruit for consumers. Although the effort by nine states to toughen the deal agreed to by Microsoft and the Justice Dept. drags on, the software maker has decided to honor part of the original agreement by modifying Windows XP with an update called Service Pack 1. SP1, now in final testing, is scheduled to be released as a free update later this summer.

SP1 makes it easier for consumers, and, more important, computer makers to change the configuration of Windows XP and add or subtract applications. It also includes a collection of bug fixes, many based on the error reports sent to Microsoft when a program crashes in XP. And it incorporates all the improvements in security that Microsoft has issued since XP was released last fall.

This update is a sign that Microsoft may finally be growing up. Four years ago, the company responded to a judge's order that it offer a version of Windows without Internet Explorer by saying such a move would keep Windows from working at all. But the new package goes beyond grudging compliance with the letter of the agreement, and actually acknowledges the spirit.

The most significant change for consumers is in the control panel used to add or remove programs. First, you can use the Add/Remove Windows Components section to get rid of features that have been mandatory parts of Windows, including Internet Explorer, Windows Media Player, Windows Messenger, and Outlook Express. Removing them does not just eliminate the icons or other means of access, as required by the proposed agreement, but actually removes the features themselves. However, since vir-

tually all PCs are set up with a copy of the compressed Windows installation files on the hard drive, the same control panel can be used to re-install these features.

A new feature, called "set program access and defaults," offers another approach. It controls what will be the default applications—and what appears on the Start menu—for five classes of what the agreement calls "middleware." The middleware includes the Web browser, e-mail, instant messaging, media player, and Java. (The service pack restores built-in support for Java, which Microsoft petulantly stripped from the original release of XP.) The "Microsoft" button chooses Internet Explorer and other standard Windows programs. The "non-Microsoft" choice selects such programs as a Netscape browser and RealNetworks' RealPlayer, if installed. The "custom" option lets you choose your default for each class of programs. Not many people are likely to delete applications such as Internet Explorer, since they are useful and disk space is rarely an issue these days. But gaining an easy way to choose the default program for viewing Web pages or listing MP3 music is a plus.

These changes are far more important to computer makers and, accordingly, to buyers of new computers. Manufacturers gain considerable flexibility in how computers are set up and what customers will see when they first turn them on. I doubt that any computer maker will eliminate Internet Explorer, or even replace it as the default, because it is the browser standard. But a manufacturer might well substitute RealPlayer for Windows Media Player, especially if Real Networks provides financial incentives.

Should you install SP1? For one thing, it's huge. While the final product is likely to be a bit smaller than the 117-megabyte test version I used, most people will probably choose to order a CD (for a "nominal fee") rather than download it. More seriously, the installation is almost as complex as an operating system upgrade, and things can and will go wrong. One of my laptops refused to boot after I installed the test version. On the other hand, many of the bug fixes that don't involve security will be available only with the service pack. Since these fixes almost always include new bugs, it would probably be wise to wait a few weeks after SP1 comes out to see what problems surface before taking the plunge.



Top Features of Windows XP, Service Pack 1

- ▶ Allows computer makers to customize the appearance of Windows' opening screen and decide what features, such as browsers or music players, will be installed
- ▶ Lets consumers remove some Windows components, such as Internet Explorer, and easily set which browser, music player, or mail program will be the default choice
- ▶ Fixes hundreds of bugs and includes repairs for all security problems discovered in XP

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Merrill Lynch research brings knowledge and insight to our Wealth Management process – a process that goes well beyond picking stocks. Stock pickers try to choose winners...Wealth Management builds balanced portfolios. Stock pickers try to time the market...Wealth Management adopts long-term strategies. Stock pickers look for the next hot fad...Wealth Management is a disciplined process.

To be valuable in Wealth Management, research has to focus on more than individual stocks. That's why Merrill Lynch research teams provide perspective on the direction and trends of the U.S. and global economies, conditions in world financial markets, financial prospects in particular industries, and specific analyses of individual companies. Plus, Merrill Lynch research informs asset allocation models and sophisticated diversification strategies that can help manage risk.

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MERRILL LYNCH WEALTH MANAGEMENT



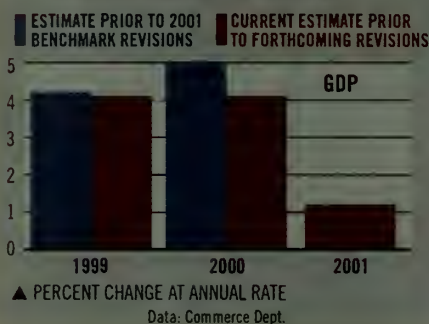
BY GENE KORETZ

NOT SUCH A HOT PARTY AFTER ALL

Growth for '98-'00 may be whittled

The numbers folks at WorldCom Inc. *et al* aren't the only ones busy restating the rosy figures they previously released to the public. At the end of July, the government will issue its annual "benchmark" revision of the nation's basic economic output data for the prior three years, and according to

WILL REVISIONS LOWER GDP GROWTH AGAIN?



Morgan Stanley economist Stephen S. Roach, it's likely to be a humdinger.

When the crew with the green eyeshades in Washington performed the same exercise last year, they cut the economy's average yearly growth rate for 1998 through 2000 by nearly a third of a percentage point and 2000's rise by nine-tenths of a percentage point. But that still left the three-year annual pace at a healthy 4.2%.

This time around, however, the result may be far less reassuring, says Roach. Based on recently released data revisions, he expects downward adjustments in such areas as capital spending, the trade balance in services (which includes tourism, education, and financial and professional services), and personal income. All of these changes could have a significant impact on estimates of economic growth.

The rise in shipments of nondefense capital goods in 2000, for example, is now pegged at only 5%, just half of the previous estimate of 10%. America's surplus in services trade last year was recently lowered by more than 12%, or \$10 billion. And revised data on wages and salaries paid to workers in the private sector in 2000 suggest that the total could be cut by at least \$100 billion, enough to slice more than a per-

centage point from the growth rate of personal income.

Growth rates of America's gross domestic product are now estimated at 4.1% for both 1999 and 2000 and 1.2% for 2001. Based on rough, back-of-the-envelope calculations, Roach thinks the growth rate may be lowered significantly for the last three years—and possibly by as much as a full percentage point for 2000.

Such prospective revisions have some worrisome implications. With less household income, America's record-low personal savings rate in recent years could look even more anemic. A larger trade deficit would imply that America's dependence on foreign capital has been greater than previously thought. And less economic growth translates into smaller productivity gains, further tarnishing some of the New Economy's luster.

Roach is known on Wall Street and in economic circles as a longtime skeptic of the New Economy, so it's possible that he may be reading too much gloom into the statistical tea leaves. Many of his past criticisms of the recent boom's excesses, however, have turned out to be painfully accurate. For their part, Washington's statisticians will have their say on July 31. Stay tuned.

DON'T BLAME DEMOCRACIES...

...for bloated social security systems

With rapidly aging populations, many nations face unprecedented financial pressures from generous social-security systems. A common theory is that this problem is a by-product of the historic shift toward democratic governments whose elderly citizens are able to use their voting power to extract high pension benefits from legislators.

Not so, report economists Casey B. Mulligan and Ricard Gil of the University of Chicago and Xavier Sala-i-Martin of Columbia University. In a study using data from 90 nations, they found that social-security policy is indeed affected by economic and demographic factors and that wealthier countries and those with older populations tend to spend more on public pension programs. However, the nature of political systems per se appears to have little impact on social-security planning or growth.

Among nations where regimes have changed, for example, Greece spent far less on public pensions when it was

ruled by a military dictatorship under democratic rule. But the reverse was true of Chile under General Augusto Pinochet, who boosted spending substantially.

In short, the authors find no evidence that democracy fosters bloated social security budgets. Indeed, their research suggests that democracies actually tend to spend a little less of their gross domestic product on social security than nondemocracies and to "grow" social security budgets a bit more slowly.

WHY THE FED MAY CUT RATES AGAIN

Revenues—and demand—need

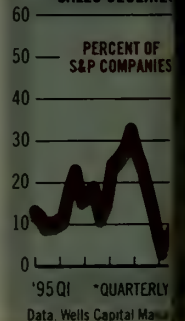
Stock market investors were humiliated by the news that some 60 of the companies comprising the Standard & Poor's 500-stock index reported quarter earnings exceeding Wall Street estimates. But economist James Paulsen of Wells Capital Management points out that nearly 58% of the same group of companies also reported year-over sales declines (chart).

The problem for the stock market and the economy, he notes, is not that earnings are less than revenues. While true that earnings have probably bottomed out, companies can't bolster bottom lines indefinitely by cutting costs in the face of falling sales. More such tactics, which include layoffs, deferred hiring, and restraints on capital investment and advertising outlays, tend to weaken underlying growth in demand, creating a vicious circle.

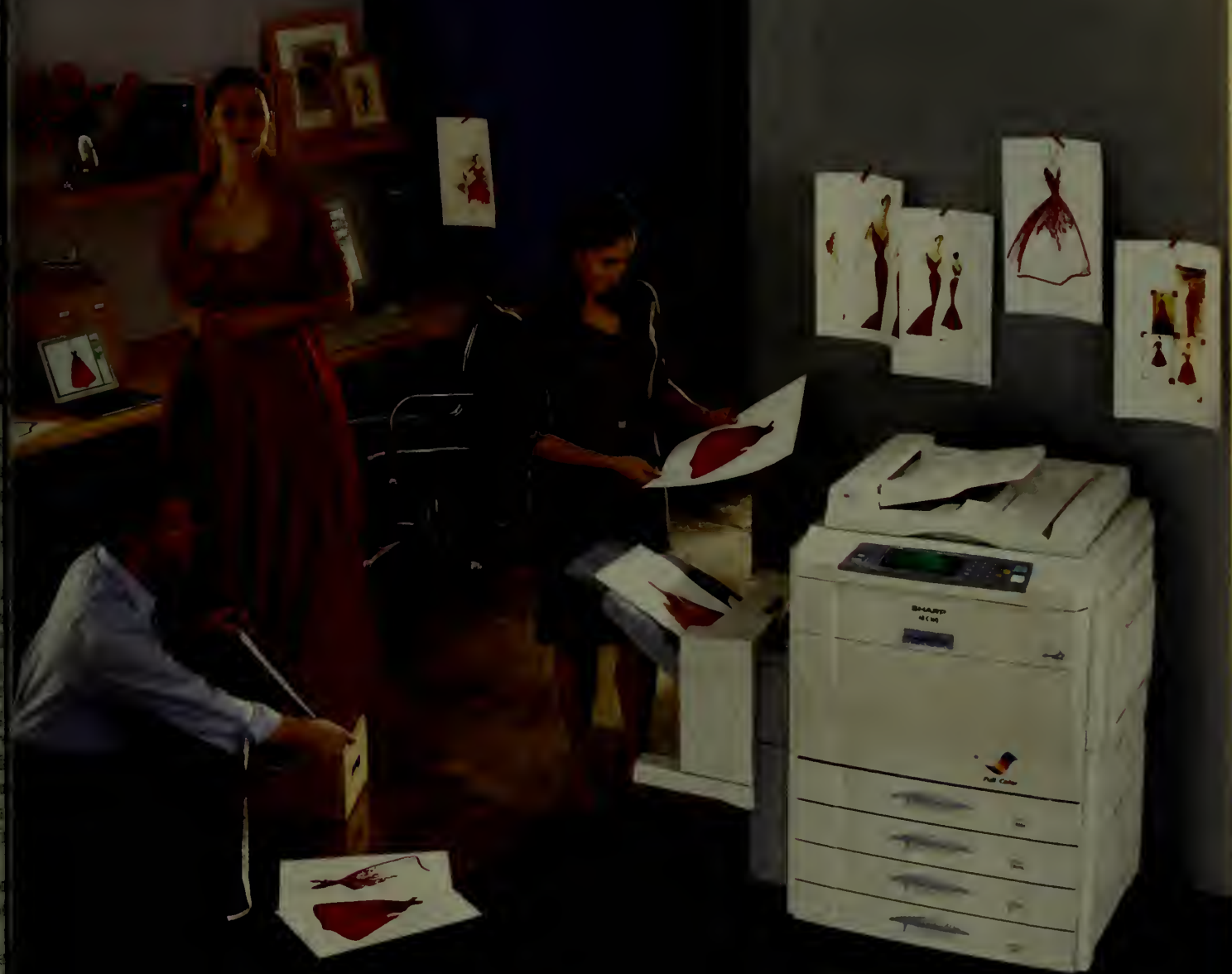
Paulsen sees a "radical disconnect" between Wall Street projections of double-digit profit growth in the year ahead and the 10%-plus year-over decline in revenues reported by industrial companies in the S&P-500 last quarter. To fuel a solid revival in profits and economic growth, he says, policy officials in Washington need to find a way to stimulate final demand more aggressively. That's one reason why he believes the Federal Reserve is just as likely to cut interest rates this year as to raise them.

WHERE ARE THE SPENDERS?

S&P 500 COMPANIES WITH YEAR-OVER-YEAR SALES DECLINES



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BY JEFFREY E. GARTEN

FIVE STEPS TO MAKE WALL STREET SAFER FOR INVESTORS



DANGER:
If trust in corporations isn't restored, the U.S. will see growth, innovation, and its role as a global economic leader wither away

What worries me about the stench coming from Corporate America is not its impact on the economy, because America's resiliency is awesome. It isn't that scandals may be causing the dollar to sink, because the greenback was overvalued anyway. Nor am I concerned that errant CEOs will escape punishment, since the feds are finally on the case.

No, what bothers me most is something not so easily fixed—the erosion of the equity-based culture that emerged in recent years. There were several components to it. First, Americans came to rely on equity markets for an ever-increasing amount of their personal financial security. By the end of the 1990s, for example, investment in mutual funds reached \$4 trillion, a sixteenfold increase during the decade, with nearly 80 million individuals owning stock directly or through these funds. Individual self-reliance was in. Government paternalism was out.

Second, most companies had turned to stock-based incentives for top management and employees to drive productivity and innovation, with positive results for the economy. Third, from Seville to Shanghai, the expansion of equity markets around the world facilitated the breakup and privatization of state-owned monopolies, enhancing both customer choice and service. In addition, America's position on the world scene was enhanced by the great success of its model of a market-based equity culture.

This equity culture rested on the trust that markets reflected the real value of underlying companies—trust that is now shattered. It assumed that regulators could spot and contain transgressions—a faulty assumption, as we now know. Shareholders, employees, and the public at large believed that CEOs and their boards were effective fiduciaries for their interests. This faith has too often proven to be misplaced.

Growing popular disillusionment is reflected in the 13.4% fall of the Standard & Poor's 500-stock index in the second quarter; in opinion polls that show collapsing confidence in business leaders, recently society's heroes; in the drop in foreign capital coming into the U.S., once a mecca for equity investors; and in conversations about how the markets are rigged that are taking place in barbershops, restaurants, and other everyday meeting places.

The alternative to equity culture is heavy-handed government that saps growth, innovation, and economic freedom. Yet given the extent of corporate malfeasance, the only way to restore investor confidence is for both CEOs and

Washington to push for reforms as sweeping as those instituted at the turn of the century in the 1930s. Most of the necessary elements are contained in the proposals coming from the New York Stock Exchange, the Securities & Exchange Commission, Congress, and various business groups. Here are some key imperatives:

■ **Regulate auditors.** A new oversight body should be established, reporting to the SEC. It should set auditing standards, license auditors, and have the power to punish transgressors. To guarantee independence and resources, it should be funded by every publicly listed company.

■ **Revamp CEO compensation.** The magnitude of stock options—and the fact that they were treated as a company expense—gave executives too much incentive to cut corners to pump up stock prices in the short term. In the future, options should not be exercisable for five years, and they should be exercisable only if company performance exceeds the S&P 500. They should also be charged against corporate income when they are cashed in. Better yet, executive stock should be rewarded in stock that must be held for a number of years so CEOs can win or lose with the rest of long-term shareholders.

■ **Make CEOs and boards accountable.** The SEC should endorse national guidelines for all publicly listed companies doing business in the U.S. Among the provisions: CEOs and CFOs must personally warrant that financial statements provide a full and accurate picture of their companies' financial positions, including critical underlying trends. Also, only must boards be more independent but not more numerous. Audit, compensation, and governance committees should be held more clearly accountable for the basic policies of the companies they represent.

■ **Keep up pressure on Wall Street.** Among the most egregious conflicts of interest has been the way analysts have been pressured and paid to recommend stocks simply to curry favor with the issuing companies. Until it's clearer how effectively Wall Street will police itself, the SEC should issue public progress reports on its efforts to limit banks' moves to eliminate conflicts.

■ **Modernize accounting.** Designed for the Industrial Age, accounting needs to deal with the global, financially complex, knowledge-based economy, including derivatives, off-balance-sheet items, and intangible assets such as research and development capabilities. The best ideas from around the world must be combined into a high-grade set of international standards.

No one can guarantee that these measures can save equity culture. But can we afford to try less than a Herculean effort?

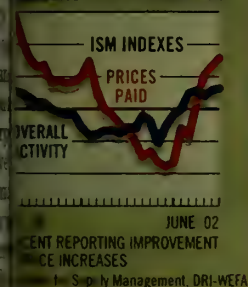
Jeffrey E. Garten is dean of the Yale School of Management. A former investment banker, Garten is the author of *The Mind of the C.E.O.* (jeffrey.garten@yale.edu).

DON'T LET THE SECOND QUARTER GET YOU DOWN

Both consumers and companies look ready to give growth a new kick

U.S. ECONOMY Four percent is very good economic growth. Keep that in mind—and repeat it often—when news about second quarter's dismal performance rises to a feverish pitch. The latest data suggest that real gross domestic product grew at an annual rate of 2% or less during the spring. But since that followed a 6.1% jump in the first quarter, the U.S. economy grew at an impressive pace of about 4% for the first half. More important, nothing in the latest trends suggests the economy can't grow at least 3% in the second half.

THE PRICING POWER IS MAKING A COMEBACK



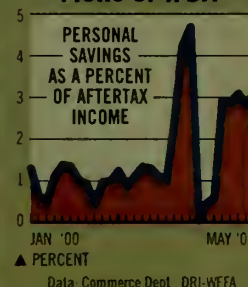
Whether development, however, signals real trouble in the U.S. economy. Other, newer trends will allow momentum to build in the second half. Consumers, for instance, will benefit from cheaper fuel and low mortgage rates. Capital spending is showing signs of life after a slump, while some pricing power may be in the pipeline (chart), which will improve the profits outlook. Inventories are set to grow, and a weaker dollar will boost exports. Add it all up, and the U.S. economy is ready to wake up from its spring nap. If there's a risk to the outlook, it's how investors will handle news about this bump in the road.

MAIN SOURCE of last quarter's weakness was a drop in household spending. Real consumer purchases edged up just 0.1% in April and were flat in May. Retailers blamed poor weather for keeping shoppers out of stores in May, and weekly retail surveys showed that sales bounced back in June. Plus, the reintroduction of zero-percent financing suggests vehicle sales will increase in coming months. Even so, real consumer spending probably rose at more than 2% last quarter. Excluding the weakness related to September 11, that pace would be the smallest quarterly gain in five years. Ever since the tax re-

bate program began last summer, consumers have been curbing their spending in favor of savings. The extra cash was a cushion against possible job loss and an offset to stock portfolio declines. In May, the savings rate was 3.1%, up from 1.1% in May, 2001 (chart).

Will consumers keep holding back? Probably not. Jobless claims stayed under 400,000 in each week of June, indicating that companies are ending their huge waves of layoffs. And real aftertax income is up 4.5% from a year ago. So even if consumers want to sock away some cash, they still have money to spend in the second half.

THE SAVINGS RATE PICKS UP A BIT



Households will also get a budget boost from falling fuel prices and continued low interest rates. Gasoline prices are down from their recent peak in early April. And 30-year fixed mortgage rates were near 6.5% in late June. Bargain borrowing costs will keep housing healthy and enable those homeowners who missed last year's mortgage refinancing boom to cash in now.

BETTER YET, CONSUMERS may not have to carry the recovery on their own since the latest data suggest that Corporate America is starting to join the rebound. The Purchasing Managers' Index from the Institute for Supply Management rose to 56.2% in June, from 55.7% in May. The indexes for production, export orders, and employment advanced, while delivery times lengthened—a sign that increased demand is prolonging the time from order to shipment.

One critical trend in the PMI data is the emergence of pricing power among suppliers. The four-month rise in the prices-paid index means some companies are regaining the ability to raise prices. Given that productivity-driven companies are reducing their costs, especially for labor, any increase in unit prices goes right to the bottom line.

Another plus for the outlook: Inventories have fallen so much, said the ISM, that their members' "customers do not have sufficient inventories on hand at this time." Rebuilding stockpiles will lift industrial production in coming months and add to real GDP growth.

The brighter prospects for pricing power and an industrial rebound may be reasons behind the nascent

Business Outlook

turnaround in capital spending as shown by the government's April and May data on shipments and orders. Capital-goods shipments have edged up so far in the second quarter, suggesting business investment on new equipment eked out a small gain last quarter. That would contrast with no growth over the winter and drops in the previous five quarters.

Equally important, new orders for nondefense capital goods excluding aircraft have also increased for two quarters in a row, meaning that demand is growing—although at a modest pace (chart). The recovery in business investment and a rebuilding of inventories will ensure a more balanced U.S. recovery, benefiting more sectors of the economy and more workers.

Some of the increased domestic demand last quarter was satisfied by foreign-made goods, and that's unlikely to change in the second half. Because of a jump in imports, foreign trade may have subtracted one percentage point or more from real GDP growth. But trade won't take as big a bite out of growth in this half. Although imports will continue to gain, export growth should pick up slowly, thanks to the recent weakening in the dollar and other upturns around the globe.

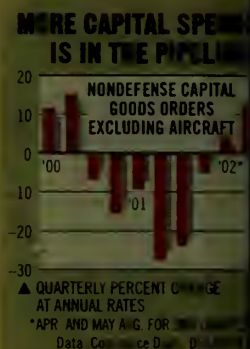
OF COURSE, risks remain in the forecast. Terrorism and geopolitical uncertainties are dangers. A spike in oil prices or an unruly drop in the dollar could cause inflation jitters. The return of federal deficits could roil

the bond market and push long-term rates high.

But the major risk to a second-half bounceback is Wall Street's reaction to the news of a second-quarter bust. When investors finally put their horror over corporate scandals behind them, they will shift their focus back to the economy. But that could happen just as data seem to show a flagging economy.

Investor disappointment would be a mistake. After all, the second quarter is history. Stock prices should be set by the earnings outlook, not last quarter's economic performance. And with pricing power returning, productivity still on a strong uptrend, and demand growing, profit reports may offer more positive surprises than negative news.

Bear in mind that the economy never runs a straight line. A burst of growth is often followed by a catching-up period. That was what happened over the course of the first half of 2002. But on average, the economy started this recovery at a good pace. We go back to the coming weeks' mantra: Four percent very good growth. And better still for job seekers, investors, and executives, the growth should be followed by solid gains in the second half.



JAPAN

TOO MUCH FAITH IN EXPORTS?

Japanese business executives have a warning for policymakers: A recovery dependent on exports is risky business, especially when your currency is rising.

The Tankan survey for the second quarter showed a significant split in confidence between big manufacturers that export and businesses that rely on domestic demand for sales. The manufacturing index jumped from -38 in the first quarter to -18 in the second, but the reading for nonmanufacturers rose by only 4 points, to -16. Moreover, the negative readings for both sectors show Japan's industry is struggling (chart).

Other data also illustrate the split in Japan's economy. Real

gross domestic product surged at an annual rate of 5.7% in the first quarter, with half the gain resulting from exports, which make up only 10% of real GDP. May industrial production jumped 3.9% from

April, thanks to increased exports of cars and electronics. But domestic car sales in June were down for the 10th month in a row, and overall household spending fell 2.3% in May.

Weak labor markets are a big reason for the softness in domestic demand. Despite the gain in factory output, manufacturing jobs fell by 390,000 in May, and the jobless rate stood at a high 5.4%. The Tankan survey found a record gap

between nonmanufacturers that felt they had too many workers and those service companies that thought they had too few.

Businesses are not hiring because they fear the export-led recovery will unravel, especially now that the yen is strengthening. The currency is up 10% against the dollar since the start of 2002, despite intervention by central banks to weaken it. A stronger yen will raise the price of Japanese exports at the same time slower growth in the U.S. will curb demand for Japanese-made goods.

That's why increased domestic spending is needed to keep the economy expanding. But Japanese consumers seem more inclined to save than spend. And that attitude means Japan's economy may lack forward momentum.





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TOO MANY ROTTEN APPLES

Will Bush's reforms be enough to calm the Investor Class?

If there's one thing George W. Bush detests, it's being behind the curve. As revelations of a corporate crime spree broke over the past months, the President stuck to his modest reform plan and turned a cold shoulder to critics demanding more aggressive action. He discouraged talk on Capitol Hill of re-regulating industry. He stood by embattled Securities & Exchange Commission Chairman Harvey L. Pitt. And through it all, he prayed that the economy would withstand the hits to the stock market and investor confidence.

Then along came WorldCom.

When WorldCom Inc. disclosed that it had uncovered nearly \$4 billion in expenses counted as capital expenditures—a bookkeeping deception that dwarfs Enron Corp.'s misstatement by a factor of six—Bush finally latched on to what the rest of the country already knew: We have reached the tipping point.

The President reacted by hastily arranging a July 9 visit to Wall Street to give a major address on corporate accountability. He also signaled his willingness to work with Democrats on a tougher version of account-

ing reform than the one Pitt supports.

Bush's top priority is to prevent the economy from spiraling back into recession. And by doing so, he hopes to avoid losing control of the House in November. "He's acutely sensitive to the economy," says Mark McKinnon, media adviser to Bush's 2000 campaign. "He has seen its impact on people. He has seen its impact on Presidents." Among them is Bush's father, who was voted out of office after the 1991 recession.

The younger Bush has been struggling to deal with the fallout from the corporate scandals since March, when he unveiled a 10-point plan to address what then seemed to be a problem confined to a handful of rogue CEOs. His proposal: create an accounting oversight board, require additional disclosures by companies, and force executives to repay stock options and bonuses inflated by false profits. But investor groups immediately complained that Bush's solutions lacked teeth.

Now, the President is prepared to raise the stakes. In his upcoming speech, he intends to call for criminal penalties for executives who certify incorrect financial statements. He also will request an infusion of funds for the Justice Dept. and the

SEC—though he's not likely to lift the \$487 million he's O.K.'d to anything like the \$776 million Congress wants (chart, page 34).

Still, there is tension among the President's team over just how tough the criminal sanctions should be. Some Bush advisers are happy with Pitt's call for executives of companies with more than \$1.2 billion in revenues to swear by the accuracy of their financial statements. If the numbers prove false, execs could be personally liable. Others want Bush to go further by calling for criminal sanctions against execs who abuse the public trust by issuing financial statements that are misleading—not necessarily false.

The internal debate also extends to whether Bush should describe the rash of corporate scandal as systemic or confined to a few bad apples, as originally claimed. The President wants to let the Investor Class know that it feels its pain—without further spooking the markets. And he wants to get Congress to act—without scorching publicans in upcoming elections. "It's a fine line," says Bush adviser Mark McKinnon, "but it's a fine line he's prepared to walk."

Despite Bush's "lock 'em up" rhetoric, there will be Administrative support for comprehensive reforms to restore the independence of the SEC and create a tough regime with real power and teeth to oversee audits.

CORPORATE CRIME



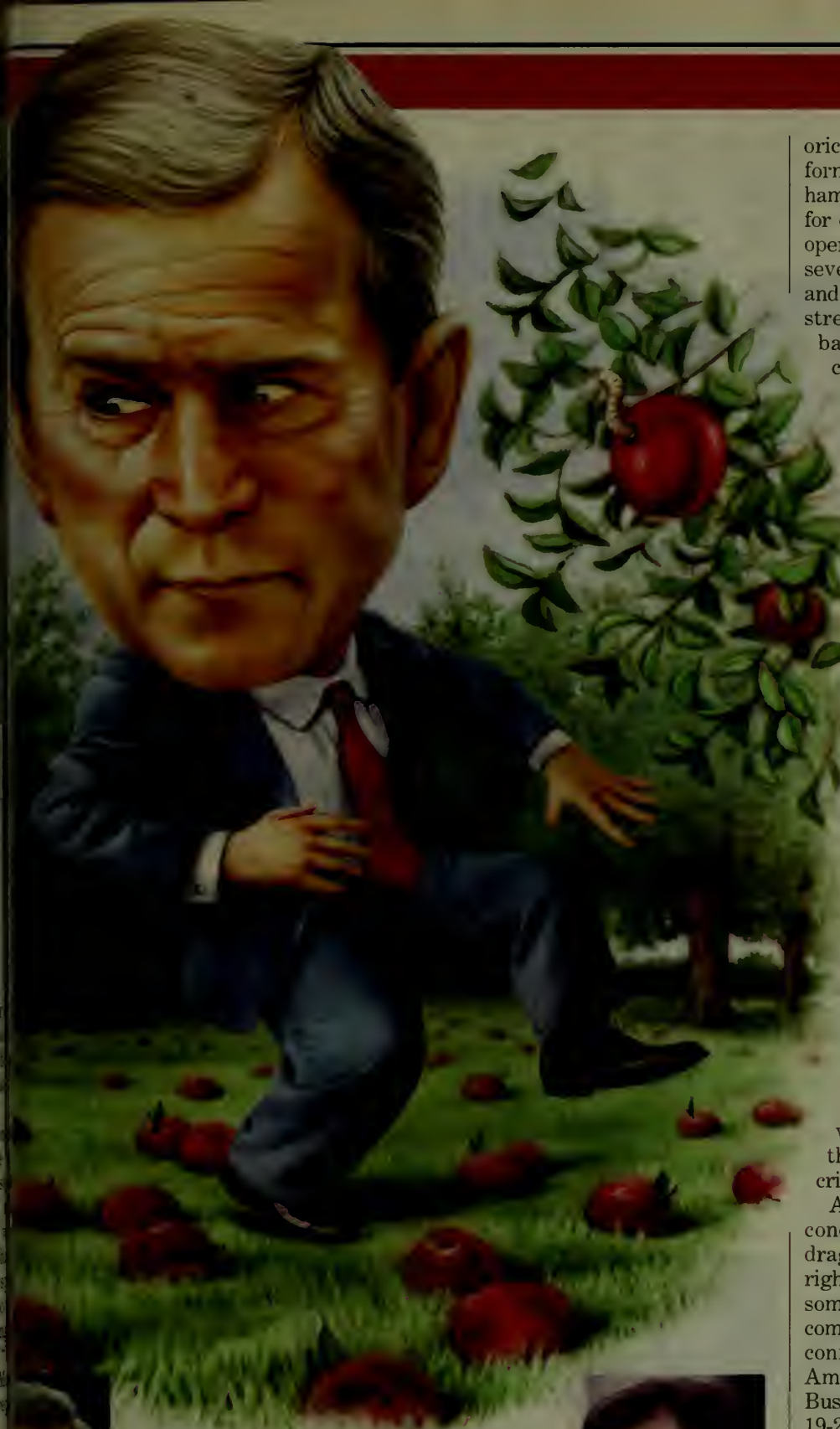
“We should be really careful about punishing everyone in the company. A lot of people lost their pensions, a lot of people lost their jobs at Andersen because of the wrongdoing of a small number of people....”

LARRY ELLISON, CEO, Oracle



“What we need to hear is that there will be Administrative support for comprehensive reforms to restore the independence of the SEC and create a tough regime with real power and teeth to oversee audits.”

SARAH TESLIK, Exec. Director, Council of Institutional Investors



oric, he is expected to resist new reforms that might tie the SEC's hands or hamstring honest CEOs. He is unlikely, for example, to call on Wall Street to cooperate with state regulators looking to sever links between investment bankers and analysts. He is unlikely to call for strengthening auditor independence by banning consulting for accounting clients. And he is highly unlikely to call for measures that would limit the use of stock options, such as requiring that their cost be deducted from earnings. Pro-investor groups say that without these reforms, wary investors aren't likely to head back into the market. "What we're looking for is acknowledgment that there are deeper problems than just trying to punish a few bad apples," says William Patterson, director of the AFL-CIO's Office of Investment.

Still, Bush's Wall Street speech won't come quickly enough for many CEOs, who are mad as hell and want Washington to do something—anything. Oracle Corp. CEO Lawrence J. Ellison told a company conference in Copenhagen on June 26: "There are crooks out in the street who will take your purse, and there are crooks in the boardroom. They should go to jail." Adds John C. Bogle, founder of mutual-fund company Vanguard Group Inc: "It looks like we were wrong to rely on the moral integrity of our corporate leaders. If we sent a white-collar criminal to Attica, I don't think we'd have another white-collar crime in this generation."

Angry execs share the President's concern that corporate chicanery is dragging down an economy trying to right itself. The ethical bankruptcy of some corporate leaders and a string of company failures are sapping investor confidence. And there are signs that Americans are growing restive over Bush's handling of the economy. A June 19-23 Pew Research Center poll found that just 33% of Americans believe he is

“The best companies already adopt the best practices. Certainly, the SEC is making it clear what best practices are...if

t to take that and make it regulation, that e all to the good.”

McKINNELL, Chairman & CEO, Pfizer



need to make sure that the regulations and laws that are in place are actually being followed.”

HARRY M. JANSEN KRAEMER JR., Chairman & CEO, Baxter

“I don't know that we need more laws. We need people running these institutions with a higher level of integrity. And we

News: Analysis & Commentary

doing as much as he can to improve the economy; 62% said he could do more.

Democrats see an opportunity in those numbers. Their logic: GOP attempts to thwart government oversight led to an atmosphere conducive to crime. In addition, the Dems are eagerly pointing out the close ties among Bush, Vice-President Dick Cheney, and many alleged corporate crooks, especially those from Enron. "The economy is falling down around their ears," says House Minority Leader Richard A. Gephardt (page 37). "If people want these problems solved, they'll want a Democratic Congress."

Senate Majority Leader Tom Daschle (D-S.D.) plans to rush a wide-ranging accounting-reform proposal by Senate Banking Committee Chairman Paul S. Sarbanes (D-Md.) to the floor the week of July 8. Business lobbyists predict Daschle will get 80 votes. And House Dems hope to maneuver Republicans into voting against strong reform efforts. "There'll be some tough votes for the Republicans," says Democratic pollster Mark S. Mellman. "This divides their campaign contributors from their voters."

That's just the beginning of the GOP's worries. Despite one of the briefest recessions in history, the stock market, which should be rebounding nicely at this point in the recovery, is back to its post-September 11 lows. Unable to distinguish honest companies from dishonest ones, investors are choosing to sit on the sidelines. While they aren't dumping their stocks, they aren't buying, either. Overseas investors, however, are bailing out, says investment managers Bridgewater Associates Inc. in Westport, Conn. As they sell off their holdings, foreign investors are driving down the dollar, which has slipped 9% against the euro since February.

The White House also worries that companies are delaying capital investments and waiting to rebuild inventories. While such moves may help bring a short-lived surge in profits, they also delay recovery. Any capital-spending rebound is likely to be postponed further because the bond market is demanding a "risk premium" in higher interest rates from many companies.

A possible retreat into recession



“Any way we can get these white-collar criminals in jail is good. And I don’t mean a country club prison in California. If we sent a white-collar criminal to Attica, I don’t think we’d have another white-collar crime in this generation.”

JOHN C. BOGLE, Founder and former CEO, Vanguard Group

seems to be on the Fed's mind, too. After the Fed cut rates 11 times in 2001, growth in the first quarter was a sizzling 6.1%. Normally, Fed Chairman Alan Greenspan would be ready to ratchet up interest rates at this point in an expansion. Instead, on June 26, the Fed kept rates steady out of concern that the second half might not be as robust as the first.

This recovery has always depended on free-spending con-

sumers. But the comatose stock market—and dwindling 401(k) retirement accounts—are giving consumers pause. In June, for the third month in a row, the University of Michigan's consumer confidence survey showed Americans losing faith in the future. Consumers said their financial situations are the most dire since the early 1990s. "If people get nervous that the stock market isn't doing anything, then they may postpone buying that new car or house," says Steve Slifer, co-chief U.S. economist at Lehman Brothers Inc. "What started out as a financial market event can become a real live economic event." Slifer has pared his third-quar-

ter growth prediction to 2.5% from

On the firing line is SEC Chair Pitt, a lawyer who has represented of the big accounting firms. Daschle former Vice-President Al Gore hatched out at Pitt as the wrong person for the job. For now, Pitt has the support of Bush and House Republicans whose vision of corporate reform closely parallels his. GOP House leaders see no need to toughen the reform package they approved earlier this year. "Legislation is the worst thing you do to solve this problem," says C Deputy Whip Roy D. Blunt (R-Mo.).

Such comments could come back to haunt House Republicans. Already Bush is signaling that he will compromise with Senate Democrats over much tougher Sarbanes accounting reform measure. Veteran business lobbyists are warning Republicans not to stand in the way of the reform for motive. "The public is going to look for somebody responsible," says Bush confidant Dirk Van Dongen, president of the National Assn. of Wholesaler-distributors. "Shame on the Republicans if they don't take bold and effective leadership on this."

Overreaching is the danger for Democrats. Like the GOP, they have received millions of dollars from business. As they go on a business-bashing spree, they risk alienating pro-growth suburban moderates. "We have to be careful to avoid class-warfare rhetoric that makes us seem antibusiness," says From, CEO of the centrist Democratic Leadership Council.

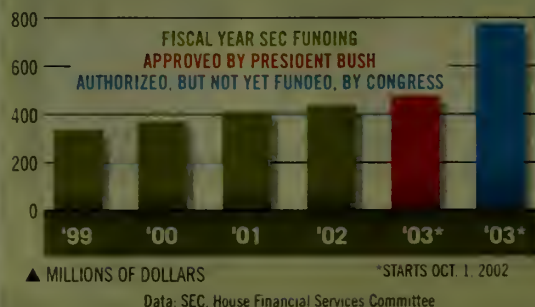
But the risks to the President's job are far greater. Corporate scandals and a lagging economy could undermine Bush's agenda for the second half of his term. His plan to create Social Security private investment funds remains in deep freeze. Further tax cuts seem unlikely amid a growing federal deficit. And Bush's push for sweeping deregulation of business will be a hard sell in Capitol Hill.

For now, the President is making sure a few high-profile CEOs land in jail. But he needs to do more than that to restore America's confidence in capitalism.

By Paula Dwyer
Richard S. Dunham, with
ra Cohn and Mike McNamara
in Washington, Amy Barrow
Philadelphia, and Arlene
Straub in Los Angeles

MORE COPS ON THE CORPORATE BEAT

As financial fraud cases mount, SEC funding is almost certain to rise next year—but probably not to the level some in Congress have proposed:



COMMENTARY

By John A. Byrne

LET'S REALLY CLEAN UP THOSE NUMBERS—NOW

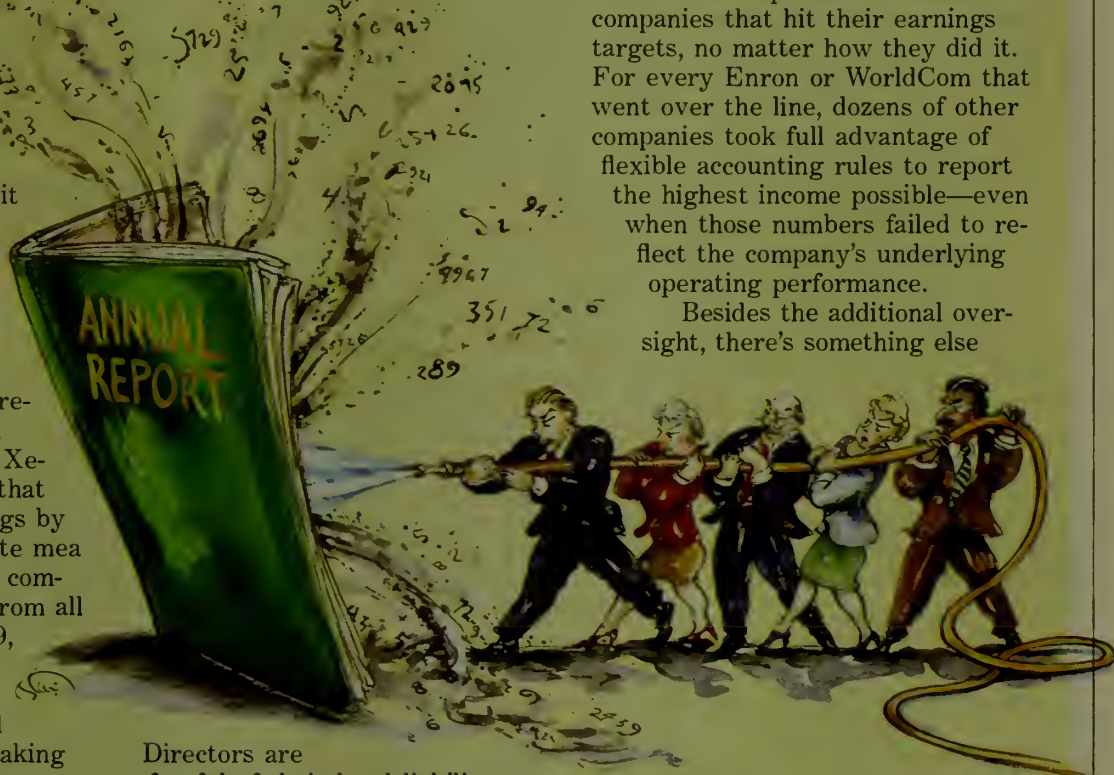
Little noticed in the shock of WorldCom Inc.'s massive accounting fraud is that it came to light only after a review initiated by the company's audit committee. Yes, believe it or not, the directors in the boardroom actually asked their auditors to take another look at the numbers. Lo and behold, that review led to the largest single restatement ever: a \$3.8 billion reduction in previously reported pretax income. Together with Xerox Corp.'s recent concession that it overstated operating earnings by \$1.4 billion, these two corporate mea culpas alone nearly match the combined total hit of \$5.8 billion from all 33 restatements in 1998, 1999, and 2000.

How much worse can it get? Plenty. It's not that we'll only see numbers as breathtaking as those at WorldCom or Xerox. But expect a tidal wave of restatements to come in what will surely amount to some sort of accounting

CORPORATE CRIME

catharsis. If ever there was a time for companies to come clean, it's now. Over the years, the quality of financial reporting has varied widely. Some companies did the bare minimum to meet accounting standards. Others were more cautious. To get beyond the current stock-market malaise, companies need to flush out the excesses so investors can regain their confidence in our financial system. It's better to take a hit now than risk dragging this out over the next few years.

Many corporate directors already are beginning to correct for their marginal oversight and governance. Today, it's a rare audit committee that isn't asking tougher questions. Even at Southwest Airlines Co., where Chief Executive James F. Parker boasts that the balance sheet is "so clean that it squeaks," the audit committee is showing "more interest in more details."



Directors are so fearful of their legal liability that many of them are asking auditors for a redo of the previous years' numbers, which will inevitably result in far more restatements. "Every audit committee I know is doing that," says Ralph Larson, former CEO of Johnson & Johnson. "You'd have to be asleep if you're not."

The numbers already show that is exactly what is happening. If restatements continue at the first quarter's pace, they will reach a record 240 this year alone. Until the mid-1980s, it was unusual for financial restatements to top more than half a dozen in any given year. Then, after regularly running about 50 or so a year from the early 1990s, these redos skyrocketed to a high of 204 by 1999. Even so, from 1995 through 2000, restatements accounted for only three-

quarters of one percent of the average annual number of reporting companies, according to Financial Executives International.

Yet most observers now agree that in the 1990s the corporate ethos reached a new and dangerous phase: Many executives began to believe that capitalism rewarded the companies that hit their earnings targets, no matter how they did it. For every Enron or WorldCom that went over the line, dozens of other companies took full advantage of flexible accounting rules to report the highest income possible—even when those numbers failed to reflect the company's underlying operating performance.

Besides the additional oversight, there's something else

driving the current cleanup. The numbers at WorldCom and Xerox are so large that most restatements—including ones that merely take a more conservative view of the numbers—could very well fall under the radar. "There is so much other bad news out there, it might be a good time to release a restatement," says Min Wu, a PhD candidate in accounting at New York University's Stern School of Business who tracks such corrections. "In good times, one piece of bad news would get you hammered more severely."

Clearly, it's in the interests of boards and management to get the bad news out now. If there is an audit committee that has yet to order another look at the numbers over the last three to five years, shame on it.

RESTATING THE GOOD TIMES



▲ BILLIONS OF DOLLARS
*INCLUDES ONLY WORLD.COM, XEROX, AND ANNUALIZED RESTATEMENTS
Data: New York University Leonard N. Stern School of Business

Senior Writer
Byrne covers
management.

'I THINK ONLY A FEW PEOPLE REALLY BROKE THE LAW HERE'

For months, the White House insisted that an ever-growing white-collar crime wave would not hurt the economy or cause President George W. Bush political problems. But when WorldCom Inc. admitted that it had improperly accounted for nearly \$4 billion in expenses, Bush wasted no time. He lashed out at Corporate America's ethical lapses four times in four days and scheduled a major speech for July 9 on Wall Street. As he helps the President prepare for the address, Chief Economic Adviser Lawrence B. Lindsey spoke to BusinessWeek Senior Writer Rich Miller.

Corporate accounting scandals are clearly spooking investors. Could they cause a plunge back into recession?

I don't believe there will be a double-dip. The consumer remains strong. Government spending remains strong. Investment is likely to pick up later this year or early next year and is unlikely to decline. If I put it all together, this year the economy will probably grow a bit over 3%.

[But] could the swooning market make people feel less wealthy and slow consumer spending?

Most of the economic effects happened in the '90s, when these excesses were occurring. And as a result, people made the wrong investment decisions. We had a \$5 trillion decline in the stock market by the second quarter of 2001, [shortly after] we came into office. That was offset very well by the [Bush] tax cut that was enacted. I think the wealth hit is behind us.

What should be done to improve corporate governance?

The 10-point plan the President laid out in March forms the basis of what needs to be done. It called for legislation, which is now happening, and stricter enforcement of the law. We've had a dramatically stepped-up level of enforcement. We've had the first-ever settlement with [Edison Schools Inc., which] adhered to the technicalities of [generally accepted accounting principles] but still didn't give an accurate picture of what was going on. There have also been a record number of corporate officials disbarred from ever holding responsible office again.

Where do you stand on the accounting-reform bill of Senate Banking Chairman Paul Sarbanes [D-Md.]? He wants an in-

dependent industry-oversight

The President called for clarifying accounting practices four months ago. And last week, the SEC put out a proposal for an accounting-standards board. My concern with the proposal is that it creates overlapping jurisdictions. His proposed board would also be responsible for securities regulation. Basically, we'd have two SECs in Washington long enough to argue that when you have overlapping jurisdictions between bureaucracies, things either fall apart or you get the cracks or you get wars. We think the House passed is more likely to successfully enforce the law.

CORPORATE CRIME

The President once said the corporate scandals were confined to a few places." Given the breadth of the problem, do you still feel that way?

I think only a few people really broke the law here. But the '90s were a period of financial excess. There's a lot of cleaning up to do, but fortunately, it usually is on the other side of a cycle that we end up with the people who abuse the process. Things were on the rise.

The Democrats charge that the SEC's deregulatory zeal created a culture that encouraged those abuses. What's your response?

I don't think it's appropriate to assign blame. But I would make the observation that they were in charge [of the White House] during a period in question.

Democrats say SEC Chairman Harvey Lowery is too close to the firms, his former clients, to get the job done. Should he be removed? That's ridiculous. He's doing a fine job. There's a record number of prosecutions going on.

Individual investors are spooked by all this. What will Bush do to assure them?

I'm not going to second-guess the President. He's proached the market very seriously. He's thought through the mechanisms of how to provide tough enforcement. That's what's needed.

UNDER CONTROL "The 10-point plan the President laid out in March forms the basis of what needs to be done.... We've had a dramatically stepped-up level of enforcement"

— LAWRENCE B. LINDSEY



PHOTOGRAPH BY CHRIS KLEPONIS/ZUMA PRESS

'THE ECONOMY IS FALLING DOWN AROUND THEIR EARS'

critical congressional elections looming, Democrats will use the recent series of scandals to paint Republicans as agents of Corporate America. Specifically, they'll blame former Speaker Newt Gingrich and his Revolution for fostering an overheating capitalism. On June 11, BusinessWeek correspondents Paula and Lorraine Woellert sat down with Minority Leader Richard Gephardt (D-Mo.) to discuss the Democrats' election strategy.

forcement. You have to ask yourself if that was the wisest thing to do.

You are urging Democrats to make corporate crime a major line of attack against Republicans in the fall. How do you intend to frame this issue?

Well, the facts are the facts. People will look at us and ask whether we did the right things to keep faith in our system of governance and our economy. Individual candidates are going to have to deal with what they did or didn't do. We now have 60 million people invested

So you're laying part of the blame for Enron, Arthur Andersen, and WorldCom at the door of the Republicans?

We have had an environment in this country, created mainly by my friends in the other party, that government was always a failure, that the tax code ought to be pulled up by its roots. That sent a message to the corporate community [to] look for loopholes or for ways not to adhere to government rules.

Are you suggesting that Newt Gingrich's Contract With America sowed the seeds for the current scandals?

If you look back at the statements made by [House Majority Whip] Tom DeLay and Newt Gingrich about the deregulation of business, I think that started to create the climate we are seeing.

Can you point to specifics?

There were attempts to tighten accounting rules that didn't get done. We had a [Republican-inspired] change in the law with regard to [limiting] stockholder suits.... During the Clinton Administration, the ability to bring those suits in state court got stopped. That took away a very important tool for the private enforcement of stockholder rights.... Congress also took energy-trading oversight out from under the Commodity Futures Trading Commission. That could have led to some of the problems we saw in California and with some of these [energy-trading] companies.

Have we seen enough Presidential leadership on this issue?

Congress is on the November ballot, [President] Bush is not.... It's really the Republican congressional leadership that you have to look at. Don't they get it? Are they tone-deaf? The economy is falling down around their ears.... If people want these problems solved, they will want a Democratic Congress.

Do you see any downside to a new raft of prescriptive laws?

I've had businesspeople say that Congress needs to deal with this problem. They know that good enforcement of sensible rules is good for business. And it's good for capitalism. ■



Congress do to fix problems that are deeply rooted in the go-go culture?

We've got to... see [if] needed regulations were relaxed or changed. We have to put those rules in place or adjust rules that were not working correctly. For instance, the question here has to do with the rules and the way accountants are governed. One issue is the role of directors, what their power is, who should choose them. It's the things we've got to look at. A national commission for corporate reform. I think the problem is big enough that it may require that kind of action. Finally, it's clear that in the past we've had efforts to either cut back or level the money we put into the SEC & Exchange Commission en-

DEEPER REFORM “ [People are] asking tough questions, like what’s happening to my retirement, what’s happening to my 401(k) ”

— RICHARD A. GEPHARDT

in stocks. And they're asking tough questions, like what's happening to my retirement, what's happening to my 401(k). It's a legitimate election issue.

THE ECONOMY

THE BOON BEHIND THE BUBBLE

Even after big losses, America is better off than before

COMMENTARY

By Michael J. Mandel

Like a film running backward, many of the corporate giants that grew quickly to prominence in the 1990s are shrinking at an even faster rate.

Icons of the New Economy, such as WorldCom, Enron, and Global Crossing, are disappearing in a haze of bad accounting. Corporate America is being forced to issue restatement after restatement, signaling that much of the earnings booked in recent years were manufactured rather than real. And the stock market is languishing: The Standard & Poor's 500-stock index is



n 17% since the start of the year. Taken together, these problems are making many economists to wonder if the New Economy boom was, in the end, only a bubble, overhyped by the press and Wall Street, and that many of the gains of the 1990s will disappear as quickly as Enron Corp. collapsed.

ear not. There's plenty of substance in the financial markets and the economy even as the froth disappears. In some sectors—notably telecommunications—have cratered, the overall S&P 500 index has more than doubled since the beginning of 1995, when the productivity gains from tech spending became visible and stock prices went off. That translates into an annual return of 10.2%. Moreover, virtually every indicator of economic health is healthier now than in 1995. In particular, wages, business-capital spending, productivity growth are all much better than they were seven years ago despite the 2001 recession.

The combination of boom followed by bust has left America better off than when it started. That may seem like cold comfort to investors who can't forget the money they've lost in the market over the past couple of years.

The evidence supports the basic premise underlying the New Economy—investment in information technology, combined with corporate restructuring, can substantially boost productivity and economic performance. Moreover, it suggests the U.S. economy should be capable of another round of solid growth. All this, of course, assumes that the market and the economy have botched out, which is no sure thing. Another terrorist attack or the discovery of major financial problems at more big companies could send the market into another tailspin. And the economy,

while clearly recovering, is vulnerable to a double-dip: Consumer confidence was off 3.5% in June, there's scant evidence yet of a sustained recovery in the labor market, and the dollar is down sharply against the yen and euro.

It's also true that, in some cases, it has taken considerable time to unwind the excesses of an out-of-control investment boom. Example: The aftershocks of the mid-'80s oil bust in Oklahoma and Texas continued to be felt for years. And more than a decade after Japan's stock market started to slide in 1990, the nation still has not recovered from its post-bubble hangover.

For now, though, it appears that the U.S. is coming out of its investment boom in far better shape than Japan did.

Despite the financial markets' dips and spikes, about half of the stocks in the S&P 500 have produced average annual returns in excess of 10% since the beginning of 1995. Even the tech-heavy Nasdaq turned in an annual return of 8.3% over that stretch.

Out in the real world, moreover, the economy is doing just fine. Inflation-adjusted wages are up 13% over the past seven years—the best jump in three decades and a boon for most Americans. Inflation, outside of food and energy, is only 2.5%, down from 2.9% in 1995. And productivity growth over the past three years is still running at a 3.1% rate—far faster than the 1.5% seen in

the first half of the 1990s and the entire 1980s.

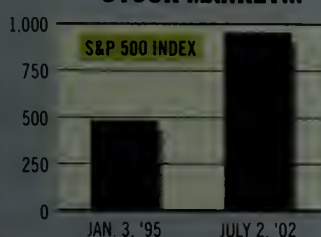
Indeed, productivity growth has been so strong that it can withstand even expected downward revisions in the economic data. At the end of July, the Commerce Dept. will issue revised estimates for the past couple of years that could reduce 2000's reported gross domestic product and productivity growth by as much as a percentage point (page 28). But even if that happens, the three-year productivity growth rate will still be a very solid 2.7%.

The strength of productivity gains is the best way to tell if the boom was justifiable exuberance about new technology or a mass suspension of rational thinking. Historically, speculative bubbles are followed by a period of weak productivity growth and low investment as businesses find themselves stuck with low returns from their capital outlays. Japanese companies, for example, invested heavily in new machinery during the golden years of the late 1980s. But this capital spending never paid off: After the boom ended, output per worker in Japan rose at less than 1% annually for the first half of the '90s. In effect, the spending was wasted.

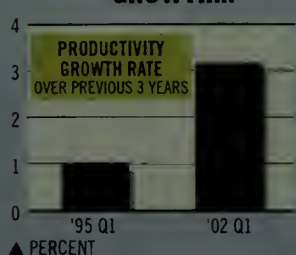
In contrast, U.S. companies generated big productivity gains even while the economy was in recession last year. That's highly unusual, and it suggests that the info-tech investments of the 1990s are finally paying off, though perhaps with a longer lag than expected. That has implications for future spending as well: As companies see the benefits of their past investments, they'll be more

WHAT REMAINS AFTER THE POP:

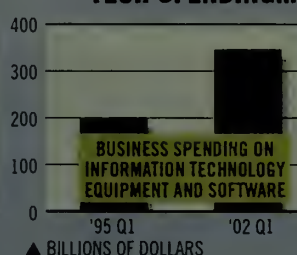
A HIGHER STOCK MARKET...



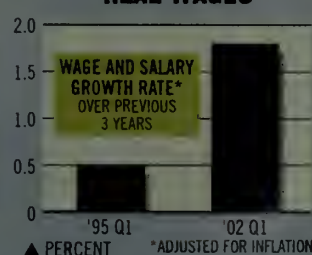
...FASTER PRODUCTIVITY GROWTH...



...INCREASED TECH SPENDING...



...AND RISING REAL WAGES



Data: Bureau of Labor Statistics, Bureau of Economic Advisers, Bloomberg Financial Markets

willing to put money into similar projects, especially if profits start to rebound in the second half of the year.

In truth, though, companies never really stopped spending. Despite the Nasdaq's bad performance and Silicon Valley's gloom, business spending on IT gear and software is about 75% higher today than it was in early '95, according to the Commerce Dept. Even shipments of non-defense communications equipment—the hardest-hit sector—are up by about 40% over the past seven years.

These gains are reflected in the financial reports of the leading tech companies, which show just how much the demand for technology has increased. For all their current problems compared with the height of the boom, Intel and Sun Microsystems have about doubled their 1995 sales, while Microsoft's revenues have more than quadrupled. And Cisco Systems Inc., despite having absorbed a disastrous inventory write-off in 2001, reported sales in the latest quarter of almost \$5 billion—more than eight times its sales of \$581 million in the first quarter of calendar 1995. That's a striking increase in growth, even if much of it came through acquisitions.

Surprisingly, these tech companies have held on to much of the stock gains they have racked up since 1995 despite the massive plunge in tech equities over the past couple of years. Adjusted for stock splits, the share prices of both Microsoft Corp. and Cisco have risen by almost 600% since 1995, or at about a 29% annual rate. The stocks of Sun Microsystems Inc. and Intel Corp. did a bit worse, with about a 20% annual gain over the same period. Overall, S&P's information-technology index rose by 125%, which translates into an 11% annual rate of return. Spectacular? No, but it's nothing to sneeze at.

The other pillar of the New Economy, financial services, has also stood up well. The boom of the 1990s was built in large part on the ability of businesses to raise cheap capital and the increased participation of individual Americans in the financial markets. That pumped up financial stocks, which collectively almost quadrupled in value from 1995 to the peak of the market in 2000.

Given the bear market and the general distrust of Wall Street and Corporate America

these days, one might expect that a lot of these gains would have dried up. But the combination of low interest rates, the housing boom, and the continued flow of new corporate bonds has meant that the financial sector has prospered. Financial companies have actually added 24,000 jobs over the past year, and profits are close to record levels.

As a result, the S&P's financial-services index is down by only 18% from its early 2001 peak. All told, the sector has shown a 17% annual return since 1995, with financial-services companies some of the biggest gainers of the past seven years, reflecting the increasing importance of the financial sector in the economy. The share price of Capital One Financial Corp., the credit-card company, is up almost 1,000% since the beginning of 1995, while Lehman Brothers Inc. is up about 700%.

Even financial companies that have taken heat for bad behavior are holding their own. Take Merrill Lynch & Co., which was publicly pilloried by New York State Attorney General Eliot Spitzer for producing misleading analyst recommendations and conflicts of interest.

At \$37 a share, Merrill's stock is worth half what it was at the end of 2000. Nonetheless, it's more than four times higher than its split-adjusted share it traded at the beginning of 1995, when the stock market boom started. That's not to say

the U.S. economy didn't develop some real excesses in 1999 and 2000. Dot-com mania, especially toward the end, was clearly unconnected to economic or business realities. In telecom, a combination of deregulation and overconfidence in new technology sent telecommunications stocks first spiraling

upward and then plunging.

There were other bubbles, too. Like telecom, the electric and gas-utility industry was hardly all it was cracked up to be by its promoters—call it the "Enron bubble." Deregulation, just as the boom hit, many utilities also went through a spending-and-borrowing spree. They engaged in financial engineering to make stodgy companies look more like high-powered earnings machines. Of course, energy trading and all the other attempts to dress up utility turned out to be no more than smoke and mirrors.

Right now, most media investor attention is focused on uncovering the wrongdoing that permeated some companies in the 1990s—finding ways to prevent it in the future. That's as it should be. But it helps to remember that even after a two-year bear market the New Economy has left American consumers, investors and companies in better shape than they were in when the boom started.

Mandel covers the economy from New York.

The
premise of the
New Economy—that IT
investment plus
restructuring boosts
productivity and
growth—has
proven true

WHAT'S REAL, WHAT'S NOT...

Since the boom began in 1995, stock prices across much of the economy have performed well, while some sectors have given up most of their gains. Here's the breakdown:

PERCENT INCREASE IN STOCK PRICES, 1/3/95-7/2/02*

FINANCIAL SERVICES <i>Banks, brokerages, insurance companies</i> 224%	HEALTH CARE <i>Drugs, biotech, managed care</i> 202%	CONSUMER STAPLES <i>Food, housewares, personal care</i> 128%
INFORMATION TECHNOLOGY <i>Hardware, software, services</i> 125%	INDUSTRIALS <i>Machinery, transportation, business services</i> 115%	CONSUMER DISCRETIONARY <i>Autos, media, retailing, apparel</i> 107%
BASIC MATERIALS <i>Aluminum, chemicals, steel, paper products</i> 39%	UTILITIES <i>Gas and electric companies</i> 17%	TELECOM SERVICES <i>Telephone and wireless companies</i> 1%

*Based on S&P 500 Sector Indexes Data: Bloomberg Financial Markets

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MEDIA

DASHED DIGITAL DREAMS

Vivendi's marriage of content and the Web isn't the only one in trouble

When pressed a few weeks ago about what his company had done to marry entertainment with Internet and wireless technologies, Vivendi Universal CEO Jean-Marie Messier insisted that the so-called digital convergence had arrived. His proof? For an extra \$2.50 a month, Vivendi cellular customers in France can select snippets from songs by such Universal Music Group artists as Eminem or Sheryl Crow for their cell-phone ring tones.

That's it? A decade after Hollywood moguls and Silicon Valley propellerheads alike began predicting the imminent arrival of a phenomenon they jokingly called Siliwood, there is precious little to show for it—at Vivendi or anywhere else. The half-dozen media companies that made the most serious forays into uncharted e-territories have since pulled back, including Walt Disney, AOL Time Warner, and Bertelsmann. In Messier's case, the attraction had some mighty serious consequences. On July 1, the company's board forced him to resign, largely due to his own missteps and scant results from his digital-convergence strategy.

For a while, many media execs dreamed that by snatching up Web startups, Net and wireless-distribution systems, and cable-TV companies, they could create a new world. It was to be a utopia in which every kind of media—from movies to games to music—could be delivered to anyone, anytime, and anywhere via every imaginable gizmo and gadget.

Best of all, this "content" would be interactive: Consumers of digital fare would be able to choose one of several movie endings or shop until they dropped at a virtual mall. All of it was going to be paid for by advertising or micropayments attached practically in-



CONVERGENCE: SO FAR, EMPTY PROMISES

A handful of major media companies fashioned strategies that wed content and Internet distribution, but they never panned out. Here's a rundown:

VIVENDI

The purchase of Universal's movie and music businesses in 2000 was meant to enable Vivendi to sell content via the Web. Instead, investors lost faith in CEO Jean-Marie Messier, and the stock plummeted 80% in two years. Messier was forced to resign on July 1.

AOL TIME WARNER

The marriage of AOL and Time Warner was supposed to deliver an array of new programming through the world's largest ISP. Now, with the ad recession, it's years before those ambitions are realized. Meanwhile, its shares are down 77% since the \$81 billion merger in early 2000.

WALT DISNEY

It created its own separately traded Internet Group in 1999 after paying more than \$400 million for Web properties Starwave and Infoseek. In 2001, it sold much of the operation, including its Internet Network, and recorded an \$820 million loss.

ply to each activity, like buying a
one bite at a time. It was to be
next bonanza—topping TV and the
onal computer.

essier's fall raises new questions
t when, and even if, the conver-
e will pay off. Some companies will
out completely. Vivendi is expected
onsider spinning off its U.S. movie,
and music operations. Others—es-
ally AOL Time Warner—are under
nse pressure to prove that conver-
e can still work. Only the persistent
well-capitalized will be able to wait
the storm and emerge as powerful
ers when, perhaps years from now,
dreams of convergence may come to
ion. "What we've seen here is a
e dawn," says media consultant
er Kreisky. "Convergence is really,
ly hard work."

s prospects have never looked so
Combining media businesses with
rnet distribution and cable-TV sys-
s was the rationale for one pricey
ision after another at the height of
Net boom. It was why Vivendi
led out \$34 billion for Seagram and
Universal movie and music busi-
es and why Time Warner sold itself
America Online in a \$81 billion all-
ock deal.

But now these companies are be-
ing punished mercilessly by in-
vestors who don't like the loads
of debt piling up and don't
want to finance the additional
\$26 billion it will cost to fin-
ish providing broadband In-
ternet service to every
cable home—
on top of \$60
billion

write-off. Its stock is down 53% in
s. It's still betting on movies.com.

BERTELSMANN

ise from the privately held German
ant was that it would be a leader in
books and music over the Internet. It
efunct Napster earlier this year, but
ann's Web sales remain dismal.

PRIMEDIA

isher's \$690 million acquisition in
bout.com, a network of Internet
as intended to leverage its slew of
s on the Web. It didn't happen.
imedia's shares trade at about
wn 97% from two years ago.

spent already. They're growing weary of
reading the tea leaves of earnings be-
fore interest, taxes, depreciation, and
amortization (EBITDA), a measure used
by media companies that hides the im-
pact of their debt.

Watch for a reversal of the hype-and-
buy trend. Fee-hungry investment
bankers who put these hybrid media
companies together will begin to break
them apart. "For years,
Wall Street rewarded com-
panies doing the most deals
at the quickest pace with
the best stock values," says
Arthur Gruen, president of
media consultant Wilkofsky
Gruen & Associates. "Now,
investors are looking more
closely at the quality of
profits. That could mean we
see another cycle, like in the
1980s, of deconsolidation."

Given the ubiquity of the
Net and growing access to
high-speed cable connec-
tions, there's still a chance
that many of the digital dreams of me-
dia companies will come true. The big
question remains when. For years, the
revolution was supposed to be just
around the corner. Even now, many in
the industry remain convinced that con-
vergence will soon blossom. Tech market
researcher Jupiter Media Metrix Inc.
predicts the number of U.S. households
with high-speed Net access will rise to
20.6 million in 2003, from 5.2 million in
2000. That, true believers maintain,
should translate into huge growth of
online revenues.

Maybe. But the days of convergence
hype are clearly history. Nobody bought
into that hoo-ha more wholeheartedly
than AOL Time Warner, and no company
has fallen as hard. Its stock, now trad-
ing at just \$12 a share, has lost more
than \$100 billion in market value since
the merger closed in January, 2001.
Newly elevated CEO Richard D. Par-
sons pledges that he hasn't given up
the vision that spawned the merger—
and he has no plans to sell or spin off
AOL. For now, though, the AOL unit ex-
ecs are focusing on incremental changes,
trying to boost ad revenues and buffing
the flagship service with more search
functions and easier broadband access.

What Parsons and other media
moguls do next will determine which
companies could eventually emerge as
winners in the digital world. When it
comes to producing compelling content
for broadband services, AOL should have
left others in the dust. But so far the
company isn't exploiting its natural ad-
vantages. While it's featuring such
things as online movie trailers and ex-
clusive premieres of songs from Brit-

ney Spears, it hasn't tapped the treas-
ure trove of Time Warner content. AOL
won't launch a music-subscription ser-
vice until late summer because its De-
cember trial version was a flop.

There's a risk to media companies in
not being aggressive enough. While AOL
plods along, for instance, nimbler rivals
are dashing ahead. Of AOL's 26 million
U.S. subscribers, only about 1% get a
bundled broadband-access
package through AOL, esti-
mates Jupiter Media
Metrix. AOL Chief Operat-
ing Officer Robert W.
Pittman points out that
more than 3 million AOL
subscribers have lined up
broadband connections on
their own with other ser-
vice providers. But mean-
while, cable operator Cox
Communications Inc. is
coming on strong. At the
end of the first quarter, Cox
had more than 1 million
high-speed Net-access sub-

scribers, or 16% of its 6.3 million users.

Others, badly burned by earlier ag-
gressive moves, are taking a go-slow ap-
proach. In 1999, Walt Disney Co. invest-
ed \$400 million to buy Starwave and
Infoseek to create its Go Network portal.
But amid disappointing results, Disney
shut down the operation just two years
later. It still plans to distribute its movies
and TV shows on the Net and through
wireless devices, but the grand strategy
is kaput. "Some people tried to build
their business models on aggressive pro-
jections. Those of us who had more mod-
est expectations are feeling a little more
comfortable right now," says Peter E.
Murphy, executive vice-president of
strategic planning at Disney.

One lesson from the boom-and-bust is
that media companies may not have to
own Net outlets to make the most of
their opportunities on the digital fron-
tier. Instead, owners of content can bar-
gain with independent distributors to
carry their music, movies, and other
media. Viacom Inc., for instance, decided
not to get into the distribution busi-
ness. "We figured if we offered the best
'oh, wow' programming out there, ad-
vertisers would pay up," says Richard
Bressler, Viacom's chief financial officer.

If the ultimate benefits of owning
both content and distribution are still a
long way from being realized, the near-
term penalty has clearly arrived. Media
executives who bought into the conver-
gence craze are now paying a steep
price for their fascination. And none
more than Jean-Marie Messier.

*By Tom Lowry in New York, with
Ronald Grover in Los Angeles and
Catherine Yang in Washington, D.C.*

One lesson is you don't need to own Web outlets to get Web distribution

MEDIA

WHAT WILL HAPPEN TO VIVENDI'S GOODIES?

Buyers are at the door, but shareholders may not get great deals

Jean-Marie Messier is gone, but the company he created lives on. For how long, though? That was the question preoccupying investment bankers and media executives on both sides of the Atlantic as Messier's reign at Vivendi Universal abruptly ended. It's a crucial issue for the industry.

Clearly, Vivendi needs an overhaul. Its market capitalization has fallen more than \$70 billion since its transforming merger with Seagram Co. in 2000. If Messier's successor tries to follow his course and keep the unwieldy conglomerate together, the company will likely be dogged by the same investor fear and distrust that overwhelmed Messier. But putting Vivendi's assets on the block may not be feasible in current market conditions. Indeed, the company's fragility was underscored when shares plunged 25% on July 2, the day after Messier resigned, fueled by a debt downgrade and reports

JEAN-MARIE MESSIER
Brought down by investor distrust

about Vivendi's accounting practices. "It is complete panic out there," says an investment banker close to the company.

Much will depend on Messier's successor. There are several candidates, but one stands out: Jean-René Fourtou, the vice-chairman of French-German pharmaceutical group Aventis. Fourtou couldn't be more different from Messier. The low-key, 63-year-old Fourtou has never squired a starlet to a Hollywood screening and probably thinks Eminem is a candy. But he's well-respected by President Jacques Chirac's inner circle and has plenty of experience in cross-border dealmaking, assets that could help as he charts a new course for Vivendi.

The Hollywood rumor mill is already cranking out scenarios for the fate of Vivendi's crown jewels—its Hollywood and publishing assets, with combined revenues of \$15 billion last year. These include not only good performers such as Universal Studios and Universal Music but also the former cable-TV holdings of USA Networks, which Messier bought last year from Barry Diller for \$11 billion.

One option is to spin off the media

RETHINKING VIVENDI

Options for the new CEO

ENTERTAINMENT AND PUBLISHING

Spin off a separately listed company, incorporating Universal Studios, Universal Music, VU Publishing, and former USA Networks TV holdings. Value: \$20 billion to \$28 billion.

PAY-TV

Sell Canal +. Value: up to \$5 billion.

TELECOM

Sell stakes in France's Cegetel and other holdings. Value: up to \$7 billion.

UTILITIES

Continue selling off 42% stake, currently worth \$4.7 billion, in Vivendi Environnement.

Data: BusinessWeek

properties as a separately listed company that Vivendi would control. But what about Diller? The chairman of shopping company USA Interactive Inc. says he doesn't want his company to buy any of Vivendi's assets. But Diller personally owns a 1.5% stake in Vivendi's TV film operations. One script hot on the cocktail circuit: Diller plays a management role in a spun-off entertainment company or gains control in a leveraged buyout. Another potential buyer is Germany's Bertelsmann, which has \$7 billion in cash it can use in acquisitions. "Bertelsmann has been kicking around Hollywood for years, trying to create their own studio," says a former top studio executive.

Vivendi's European assets also likely to go. Because of French restrictions on foreign ownership of media, pay-TV group Canal+ would probably go to a French company such as Lagardère Media. Vodafone Group CEO Chris Gent is eager to grab Celtel, a French phone company in which Vivendi holds a 44% stake. "Just see those two properties would go a long way toward getting the finances in order," says Michael Nathanson, an analyst with Sanford C. Bernstein & Co.

But getting a good deal for Vivendi shareholders won't be easy. Global markets are depressed to begin with, and Vivendi is in no position to haggle—especially now that its debt rating is at junk levels. Indeed, Vivendi is in turmoil that analysts can't even agree on its breakup value, with estimates ranging from \$18 billion to as much as \$50 billion. That's one reason the CEO may move cautiously on a sell-off.

Fourtou is likely to enjoy strong support from the French majority on Vivendi's board. He's a co-founder of Entreprises et Cité, an exclusive club of 30 French CEOs that includes several current and former Vivendi directors. Of course, the clubby member of France Inc. protected Messier far longer. This time, they'll have to work more about protecting shareholders on their own.

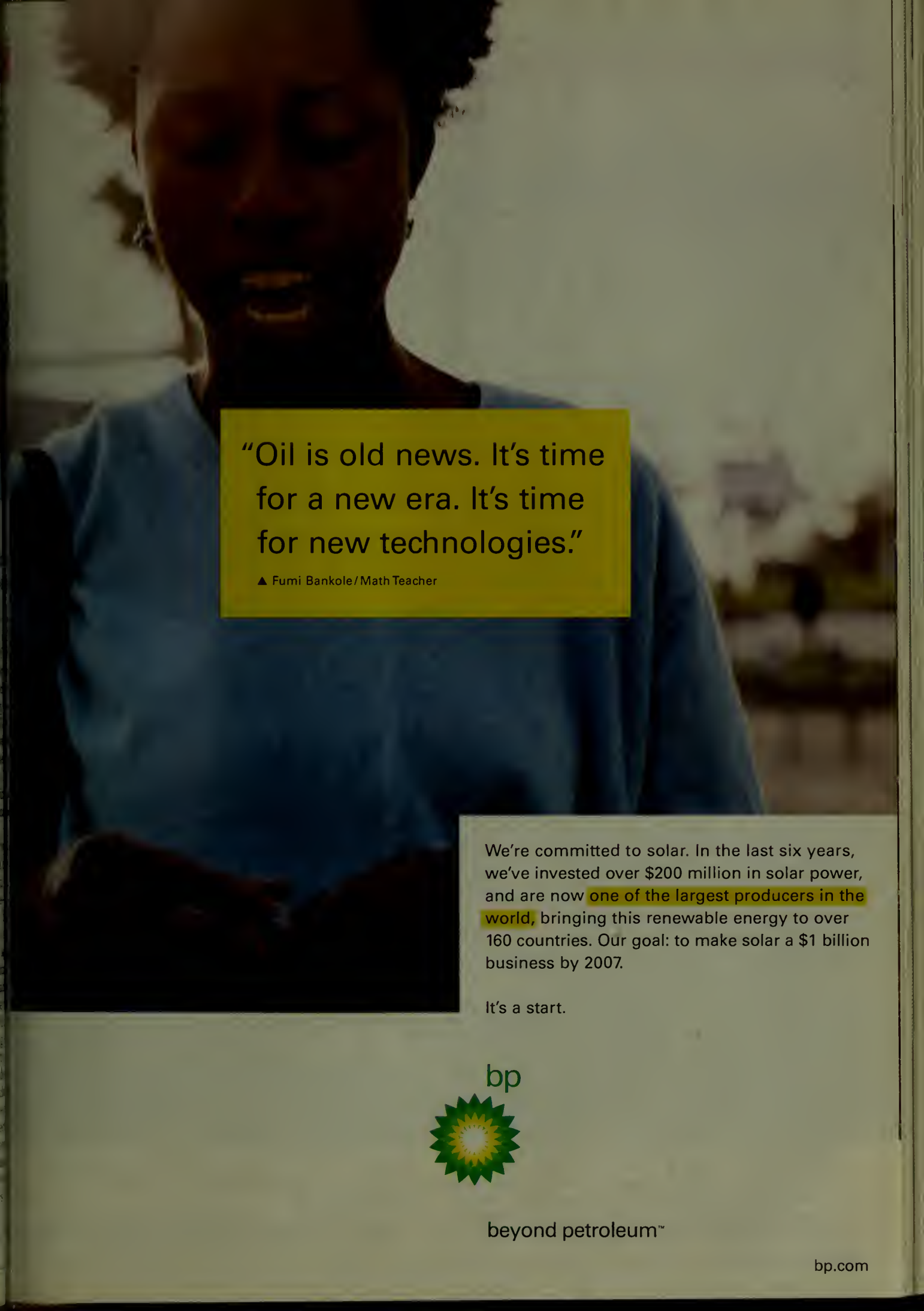
By Carol Matlack in Paris,
Ronald Grover in Los Angeles



JEAN-RENE FOURTOU

Has the support of many in the board





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for new technologies."

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COMMENTARY

By Linda Himelstein

A CLASS ACT IN THE VALLEY

I had a running joke with Daniel H. Case III that began the day we met. It was 1996, and I had just arrived in Silicon Valley from New York City to cover the financial-services industry. Naturally, one of my first calls was to Dan, then CEO of high-tech banking boutique Hambrecht & Quist in San Francisco.

We talked about the state of the industry: what was hot, what was not. Then he gave me what at the time seemed like a typical public-relations pitch. Dan thought I should write about how his investment bank had managed to succeed partly by doing the right thing: He insisted that, even in the take-no-prisoners business world, H&Q was, well, nice. We both had a good laugh. Then I realized he was serious.

I didn't take him up on the offer. Normally, niceness isn't much of a business story. Maybe I should have: There was a lot more to Dan Case than being a nice guy, although he truly was that. Case played an instrumental role in making Silicon Valley an industrial powerhouse. When Dan died at age 44 on June 26, after a 15-month battle with brain cancer, the world lost more than a good soul. It lost a man who serves as a reminder that Corporate America is populated by those who accomplish much good, not just by cheats and liars. At a time when business leaders inspire more scorn than esteem, Dan Case stands as a model of decency.

Throughout his career, Case was aggressive, to be sure. But he never crossed the line, say friends and competitors alike. When pitching a client, "Dan was a class act. One thing I always liked about him was that he competed on a positive basis. He talked about his strengths, not other people's weaknesses," says Sandy Robertson, former head and co-founder of rival Robertson Stephens & Co.

If a potential conflict of interest arose, Dan was quick to recuse himself, but he also tried hard to prevent those situations from coming up at all. For instance, he sat on the board of game-software maker Electronic Arts until he died, but he never did any of the company's banking business. H&Q didn't take America Online Inc. public even though Dan's brother, Stephen M. Case, was CEO.

His talents were obvious from the start. Dan joined H&Q as an intern in 1979 and rose through the ranks quickly. For two decades, he provided technology start-ups with the cash they needed to flourish. In the early days, when the Wall Street powers snubbed Valley start-ups, he took them public. Later, Dan became one of the key forces behind the Internet boom. True, many of those companies are now just a memory. But Dan's firm

advised many of tech's darlings, from Siebel Systems Inc. to Amazon.com Inc. "His clients weren't served in the gold-rush manner but with sound advice and support for the long run," says L. John Doerr, a venture capitalist at Kleiner Perkins Caufield & Byers. Since 1990, his small firm underwrote 101 tech initial public offerings, placing it fourth among all investment banks in

volume and well ahead of such giants as Merrill Lynch & Co., according to Dealogic LLC.

Case's willingness to take risks extended to his cancer fight. In May, 2001, he formed, with his brother Steve, now chairman of AOL Time Warner Inc., Accelerate Brain Cancer Cure Inc., a foundation that aims to help find a cure for this almost-always fatal disease. The organization has cobbled together a group of leading researchers, academics, and Silicon Valley power brokers. So far, ABC2, as it is known, has doled out 21 grants to medical researchers.

Dan established his foundation knowing that he would probably not live to see the fruits of his efforts. What's more, he allowed himself to become a test case

volunteering for experimental treatments and medications that might help cancer victims in the future. He paid a price, suffering painful side effects.

When I saw Dan for the last time in May, his baby face was bloated by the cancer drugs. He had lost some hair. But he was the same guy. He prodded me to get on with that "nice" story about his firm, now known as J.P. Morgan H&Q. And one last time, we had a good laugh.

Senior Correspondent Himelstein covers Silicon Valley



At a time when business leaders inspire more scorn than esteem, Dan Case stands as a model of decency

DAN CASE, WHO DIED OF BRAIN CANCER JUNE 26, EMBRACING HIS BROTHER STEVE

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The courtesy of a reply is requested

Mr. Davis

Will ☐ Will not ☒ attend

Salmon ☐ Filet Mignon ☐



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In Business This Week

EDITED BY MONICA ROMAN

TYCO GETS A BREATHER

DESPITE THE SWOONING STOCK market, troubled Tyco International managed to complete the initial public offering of its huge commercial-finance arm, CIT, on July 1. The \$4.6 billion price was well below the \$5 billion to \$5.8 billion Tyco had hoped to raise—and just 40% of the \$11.3 billion it had invested in CIT since last June. Still, Tyco insisted the proceeds from the IPO, combined with \$2.5 billion in cash it has on hand, should allow it to meet all of its debt needs at least through November, 2003.

SOUTHWEST AIR'S FAMILY FEUD

NORMALLY CHEERY EMPLOYEE relations at Southwest Airlines appear to be chilling. On July 1, the low-cost carrier and its mechanics' union

asked federal mediators to help break a contract deadlock over pay. The mechanics have been represented by the International Brotherhood of Teamsters for 15 years, and the request was the first time the Southwest employees have sought federal mediation. The move came days after union members rejected a final contract offer from the Dallas-based airline. While the company is nowhere near a strike, the move certainly signals that profitable Southwest, which also is in contract talks with flight attendants and pilots, will see more pressure from employees to share the spoils.

SPREADING THE GOSPEL OF ELIOT

THREE STATE FINANCE OFFICIALS representing more than \$200 billion in pension and other funds called on brokerage firms to follow the conflict-of-interest principles in the May agreement between New York Attorney General Eliot Spitzer and Merrill Lynch or risk losing the funds' brokerage business. The treasurers of California and North Carolina and New York State's Comptroller asked securities firms to sever compensation links between research and investment banking. The states will also require brokerage firms and money managers to fully disclose compensation they receive from companies covered by their research departments or in which their firms have invested.

DETROIT BRINGS BACK A CLASSIC

AUTO MAKERS ARE TRYING TO kick-start sales after a dismal May. To stoke consumer interest, General Motors is bringing back its 0% financing program that won over buyers last fall. From July 3 to

HEADLINER: KENT KRESA

ANOTHER UNDER-THE-RADAR SUCCESS

IT'S FITTING THAT NORTHROP Grumman's best-known product is the B-2 stealth bomber. Chairman and CEO Kent Kresa has a knack for sneaking up on his competitors.

That was the case with TRW, the Cleveland-based conglomerate that got a surprise takeover offer last February. TRW put up a fight, but on July 1 it agreed to a merger after Kresa made a sweetened offer of \$7.8 billion in Northrop stock.

The TRW deal faces opposition, chiefly from Lockheed Martin, which would compete most closely with the combined company. The

Pentagon has created a special board to review the deal, but Kresa says he is confident the merger will sail through. "There is no doubt the combination is in the best interest of shareholders, employees, and our national defense," he says.

If completed, the merger will be a final feather in the cap for Kresa, who is expected to step down when he hits age 65 next March. His likely successor? Northrop President Ron Sugar, a 20-year TRW veteran who joined Kresa's team last year.

Christopher Palmieri and Stan Crook



CLOSING BELL

WAVES OF WOE

The WorldCom aftershocks continue. On July 1, EDS shares fell 18%, to \$30.45, after it said WorldCom owed it \$150 million for unpaid services and that the telco's collapse could squeeze 2002 revenues and profits. The next day, Moody's Investors Service said it might downgrade EDS's long-term debt rating, partly due to its relationship with the troubled telco.



Sept. 3, GM is giving buyers free financing for all 2002 models except Saturns, Hummers, and Saabs. Industry experts estimate the program will cost GM almost \$2,800 a vehicle, nearly \$500 a vehicle more than in January. So why do it? When GM used 0% last fall, the company gained half a point of market share in the U.S., pushing its stake to 28.1%. Rival Ford Motor is countering GM's move with rebates between \$1,500 and \$3,000 or low-interest financing on most models.

ELUSIVE NUMBERS AT ADELPHIA?

THE RESIGNATION OF MEMBERS of the founding Rigas family after charges of self-dealing hasn't ended the infighting at Adelphia Communications. The cable company's former accountants, Deloitte & Touche, charge in a filing with the Securities & Ex-

change Commission that after the Rigas departures dependent board members withheld key documents, blocked the firm from properly completing its 2001 audit by Deloitte, which was dismissed by Adelphia on June 9, and charges that directors asked it to sign off on the audit without supporting documents. Adelphia, which filed for Chapter 11 on June 10, has since hired PricewaterhouseCoopers as its auditor. Adelphia says it disagrees with Deloitte and will respond in an SEC filing.

ET CETERA...

- IDT is offering \$3 billion for WorldCom's MFS/Brooks unit and \$2 billion for MFS.
- Warren Buffett's Berkshire Hathaway will buy apparel maker Garan for \$270 million.
- Merck postponed the sale of 19.9% of its pharmacy business unit until the week of July 14.

PROMISE TO EXPLAIN THE WONDERS OF OUR SYSTEM-ON-CHIP RESEARCH AND HOW SCOTLAND IS SHAPING THE FUTURE OF ELECTRONIC DESIGN.

BUT FIRST WE NEED TO GET PAST THE KILT THING.



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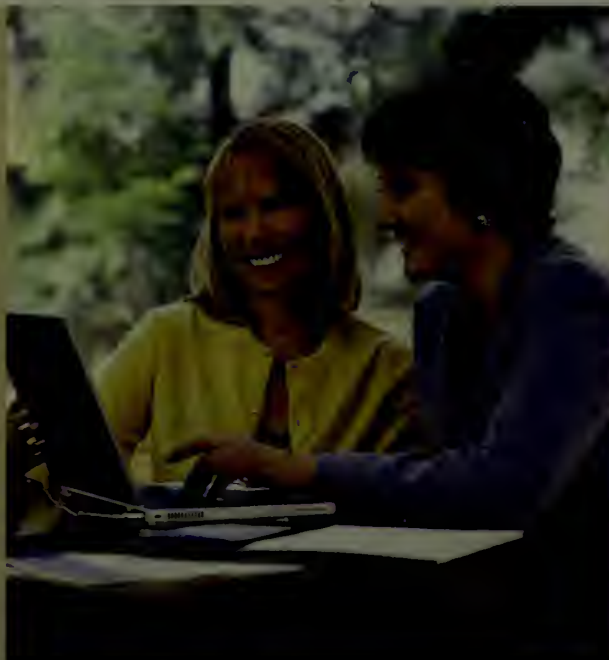


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EDITED BY RICHARD S. DUNHAM

DEMOCRATS FIND A NEW ALLY: THE GREEN GOBLIN

South Dakota's Tim Johnson is widely considered the most endangered Senate Democrat. His generally liberal voting record is a tough sell in a conservative state that George W. Bush won easily in 2000. But Democrats and their interest-group allies think they've found a way to keep Johnson afloat: a big, green life preserver.

Sparsely populated South Dakota has been inundated with radio and TV commercials from the League of Conservation Voters (LCV) and the Sierra Club slamming Johnson's GOP challenger, Representative John R. Thune, for voting to delay tighter arsenic standards in drinking water. Because the water in 18 communities exceeds federal arsenic limits, the ads have put Bush's handpicked candidate on the defensive. Now, Thune is airing response ads saying that he, too, supports stricter arsenic standards. Democrats are betting that the tactical success in South Dakota can be duplicated in enough states to help them maintain control of the Senate—and maybe even win back the House. Among GOP enviro vulnerabilities: Bush's support for drilling in the Arctic National Wildlife Refuge, his efforts to delay stronger fuel economy standards, and a flap over his commitment to Superfund cleanup.

Given Bush's close ties to the energy industry, Democrats say green issues take on added saliency amid ongoing corporate scandals. "There's no question that the Achilles' heel of both the Republican Party and the President is the environment," says Democratic pollster Mark S. Mellman.

The issue is especially powerful because it appeals to swing voting blocs. A June 19-23 Pew Research Center survey found that independents and highly educated voters disapprove of Bush's environmental record. "The environment can

be a sleeper issue," says pollster John Zogby. "To the degree [Democrats] can generate emotion and fear, it can be a very successful strategy." With Congress up for grabs, environmentally conscious voters hold the key to six Senate races, especially those in Oregon, New Hampshire, and Colorado, and at least 10 House contests, including ones in New Jersey, Michigan, California, and Arizona.

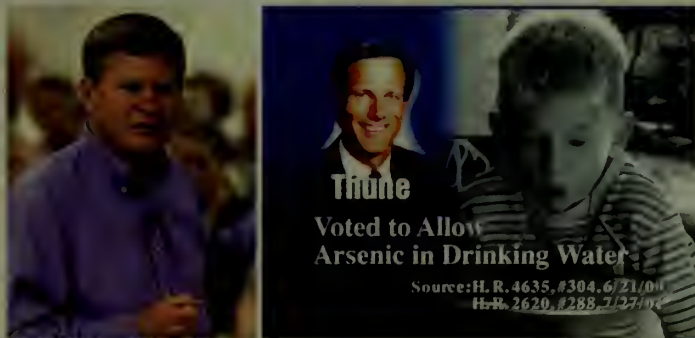
At-risk Republicans are scrambling to portray themselves as stewards of the outdoors. In Oregon, GOP Senator Gordon H. Smith boasts of his vote against Alaskan drilling, as his opponent, Oregon Secretary of State Bill Bradbury, talks up his

efforts to limit development along the state's pristine coastline. In Colorado, Republican Senator Wayne Allard, who launched his campaign from a Superfund site, points to his efforts to clean up plutonium from a nuclear-weapons plant in Rocky Flats. Dem rival Tom Strickland, a former prosecutor, touts his role in establishing Great Outdoors Colorado, which has funneled \$260 million in lottery money to wildlife groups.

It's far from certain that the Democratic strategy will succeed. In Minnesota's tight Senate race, for example, a Green Party candidate threatens to tip the election to environmentally friendly Republican Norm Coleman by siphoning votes from incumbent and staunch green Paul D. Wellstone.

Still, enviro groups are spending record amounts trying to aid Democrats and a handful of pro-green Republicans. The Sierra Club is targeting 12 key races. And the LCV has budgeted \$6 million for politics—nearly matching the \$8 million it spent in the past three campaigns combined. With the election so tight, that kind of investment could go a long way.

By Laura Cohn



TOXIC CAMPAIGN: Tim Johnson vs. John Thune

CAPITAL WRAPUP

THE FLAK-CATCHER

President Bush remains untainted by corporate scandals and by his refusal to release documents relating to his 2001 energy task force. But Dick Cheney appears to be taking heat. A June 14-17 Harris Poll showed the Veep's approval rating at 55%, 15 points behind the president's. Harris Senior Vice-President David Krane says Cheney seems to be tainted by closed-door meetings with energy execs and his past role as CEO of Halliburton, which is under SEC investigation.

MERRY CHRISTMAS

► That distant quacking you hear is Congress beginning to plan for a post-election lame-duck session. Lawmakers would like to start vacation in late July and are eager to hit the campaign trail in early October. But they have a long, difficult to-do list, topped by creation of a homeland security agency and post-Enron reforms. And Congress needs to complete 13 spending bills that will keep the government operating after Sept. 30. "We'll be here until Christmas," says one Hill veteran.

TECH WINS ONE—FINALLY

► With little fanfare, Bush has kept a long-delayed campaign promise to cut red tape for chip and computer exports. Under new rules, chipmakers won't need an export license to sell general-purpose microprocessors to China, India, and Pakistan. The regs also more than double the power of computers that can be sold to such countries without a license. Techies say restrictions—supported by the Pentagon and law enforcement—had them at a competitive disadvantage.



CHINA

THE TRICKS OF TRADE

WTO neophyte China is learning fast

In late June, Robert B. Zoellick, Washington's chief trade negotiator, let it be known that the U.S. was becoming increasingly skeptical about China's commitment to free trade. Despite joining the World Trade Organization in December, said Zoellick, China had not honored its promise to raise import quotas on corn and wheat, and was continuing to provide grain export subsidies to its own farmers in clear violation of WTO rules. Earlier this year, the U.S. waxed indignant when Beijing restricted imports of genetically modified soybeans—widely seen as a way to protect Chinese farmers. “China has not fully implemented the

WTO accession obligations,” says Allen F. Johnson, U.S. chief agriculture negotiator. “It’s going to undermine what we’re trying to do.”

This is about much more than corn and soybeans, of course. Everyone knows China will have a hard time opening up the agricultural sector because its farmers are ill-prepared to take on foreign competition. Besides, Washington has little moral leverage, given its own cynical protectionism of steel producers and farmers. That said, there is growing concern in tradeland that Beijing’s go-slow on agriculture is also happening in other crucial sectors, including banking, autos, and information

WAR OF WORDS

WHAT THE U.S. SAYS

- ▶ China is not living up to WTO promises on the importation of wheat and corn and is using a murky import licensing system to restrict U.S. grain imports.
- ▶ Beijing is using non-WTO-compliant export subsidies to sell corn to South Korea, to the detriment of U.S. exports.
- ▶ Beijing is violating the trade-related agreement on protection of intellectual property by letting counterfeiting continue.

WHAT CHINA SAYS

- ▶ Higher U.S. tariffs on steel violate WTO rules and unfairly protect its steel industry. Beijing has filed a formal WTO complaint.
- ▶ The U.S. has broken its free-trade pledge by introducing a large farm-subsidy package.

technology. Moreover, trade experts say Beijing is not fully cooperating with the WTO as it prepares later this year to review China’s free-trade commitments. “Overall, we give them a B-minus,” says Christian Murck, Chairman of the American Chamber of Commerce in China. “There’s a strong commitment from Beijing, but it’s a messy process. Some things get resolved, but other problems come up.”

One is domestic politics. China is in for a historic changing of the guard next year, and its top politicians are eager to put off the massive layoffs that WTO compliance implies, at least in the new generation of leaders in place. Moreover, various ministries and local governments are ignoring or overriding market-opening commitments that were negotiated last year by the Ministry of Foreign Trade & Economic Cooperation (MOFTEC). The State Development Planning Commission (SDPC), the ministry that issues import licenses for agricultural products, is doing its best to keep out foreign farm products. And the Ministry of Information Industry hasn’t fulfilled promises to provide equal treatment for foreign and domestic technology companies.

As other agencies drag their feet, MOFTEC seems both helpless and unwilling to intervene. Already disparaged at home for pushing unpopular trade policies, MOFTEC was further weakened

Long Yongtu, a veteran Ministry bureaucrat and the chief WTO negotiator, passed over earlier this year as China's representative to the world body in Geneva. "MOFTEC doesn't have the muscle" to push its market-opening policies, says an American in Beijing familiar with the WTO trade negotiations. "From the get-go, the other agencies have been saying: 'We didn't want this agreement.'"

While much of the current backsliding concerns agriculture, China is blocking foreign participation in other sectors, too. For example, Beijing continues to hold up approval for foreign automakers to enter the lucrative car-manufacturing business. This was supposed to happen the moment China joined the WTO. "We're still waiting," says Wang Suixin, Volkswagen China's chief representative. In the mobile handset market, the government is forcing the sales of Nokia Corp. and Motorola Inc. to source more of their parts locally than their Chinese rivals. Beijing also levies a 17% tax on imported semiconductors; mainland chipmakers pay no more than 6%. U.S. officials have urged many of these issues with Beijing, but progress is slow.

China has a perfect excuse for its go-slow posture on welcoming free trade and investment: The Bush Administration's March decision to raise tariffs on imported steel. As a new member of the WTO, Beijing has lost no time in using the global forum to protect its interests—and turn the spotlight away from itself. On June 24, Beijing joined the European Union, Japan, and several other nations to register a complaint with the WTO against the U.S. tariffs. Moreover, China's efforts to protect its industries through indirect subsidies or controlling import licenses are hardly original. The EU has long used import restrictions on genetically modified foods to protect its farmers. One could argue that China is simply learning the tricks of the trade trade.

There is some hope that once Beijing's new leaders feel sufficiently settled, they may begin to rein in the worst excesses of the wayward ministers. "China's leaders recognize that accession to the WTO is in the long-term interests of the country," says Patrick Atwood, director of China Operations for the U.S.-China Business Council in Beijing. "It will help them reform their markets and institute rule of law." That the prevailing theory, but China's domestic considerations mean trade disputes won't end anytime soon. Expect more histrionics ahead as China's economy is increasingly opened to the world.

By Dexter Roberts in Beijing, with
Magnusson in Washington

CHINA

CLEAR SAILING FOR PIRATES

For now, the WTO can't stop mainland counterfeiters

Gillette razors, Budweiser beer, Bosch fuel filters, Microsoft software. If it's a famous international brand, you can bet Chinese "entrepreneurs" are busy trying to copy it. When Beijing joined the World Trade Organization in December, it agreed to crack down on the scourge. But in the ensuing six months, the pirates have become even more audacious, making more phony foreign-branded products than ever—and shipping more of them overseas. So Washington will plead the multinationals' case before the WTO and force Beijing to honor its pledge, right?

Not so fast. Trade experts say it isn't so easy to accuse Beijing of breaking its agreements. That's because the wording of the Agreement on Trade-Related Aspects of Intellectual Property, or TRIPS, is ambiguous. While it calls for governments to create an "effective deterrent" against counterfeiting, it's vague on what that means, says Joseph T. Simone, a partner with law firm Baker & McKenzie in Hong Kong and a vice-chairman of the Beijing-based Quality Brands Protection Committee. That's a fake-fighting group that includes multinationals Compaq, Anheuser-Busch, Johnson & Johnson, Philip Morris, and Prada, among others.

So despite the howls of the multinationals, the U.S. and other WTO members may not have the legal ammunition they need to nail Beijing on the counterfeiting issue. Politics plays a role, too: Washington knows that serious pressure on the pirates from Beijing would vaporize thousands of jobs at a time when China faces rising unemployment. As a result, it's unlikely anyone will take action for the time being.

Foreign firms can only hope Beijing will impose stiffer penalties, as promised. The latest word from the govern-

ment is that new rules will be issued in July, providing for fines up to 10 times the meager amounts now levied on counterfeiters who are actually caught.

Will that make any difference? Enforcement, as always, is the key. While local branches of such regulatory bodies as the Administration for Industry and Commerce and the Quality and Technical Supervisory Bureaus are willing to get tough—particularly when paid "case handling fees" by the multinationals filing the complaints—they are loath to turn over captured counterfeiters for criminal prosecution. Why? "They don't want to pass the case on to the police," says Procter & Gamble Co. spokesman John Yam, "because they lose money." Translation: The bureaucrats won't be able to extract bribes from the pirates.

While the multinationals search for a way to curb counterfeiting, the practice is costing foreign businesses tens of billions of dollars a year, says Timothy P. Trainer, president of the International AntiCounterfeiting Coalition. And the



CUSTOMS
Chinese knock-off
auto parts pile up
in Le Havre, France

products are becoming increasingly sophisticated. Witness the growing market in China-made fakes: Gillette says bogus Duracell batteries and Oral-B toothbrushes are being sold in the U.S., while

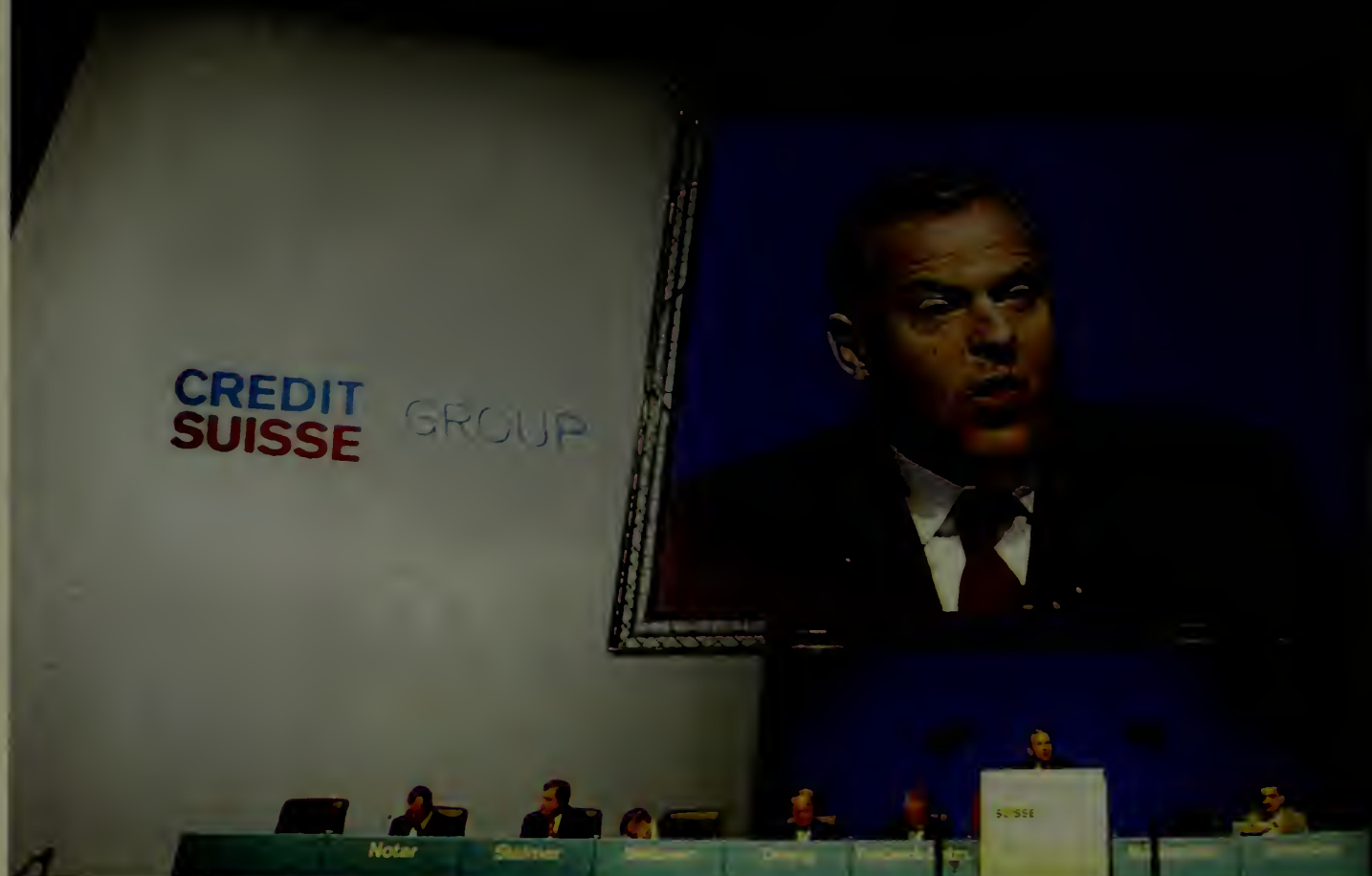
pretend Prestobarba disposable razors are on sale in South America, and Sputnik-brand blades stock the shelves in Russia (Prestobarba and Sputnik are Gillette brands). Similarly, P&G's Head & Shoulders shampoo and Safeguard soap are showing up in the Philippines, the Middle East, and Eastern Europe.

The reality is that China's entry into the WTO isn't going to stop the wave of ersatz consumables. That will require rule of law and a serious crackdown on corruption. Still, with Chinese brands themselves starting to suffer, Beijing may one day have sufficient reason to put the copy kings out of business.

By Dexter Roberts in Beijing

SWITZERLAND

ON THE EDGE



Will a radical new strategy save the day for Credit Suisse's CEO?

Lukas Mühlemann is a man under siege. On July 2, board members at the Credit Suisse Group gathered in Zurich to discuss his strategy and performance—and decide whether to keep him as chairman and chief executive. The 11-member board was unnerved by the 11% slide in Credit Suisse's stock price on June 24 after the group was forced to pour \$1.3 billion of fresh capital into Winterthur, its money-losing insurance division. All told, the

group's shares have fallen almost 35% this year, making it the worst-performing big-bank stock in the U.S. or Europe.

As *BusinessWeek* went to press, it was unclear what action the board would take—whether to order a major restructuring and change of leadership, or stay the course. But whatever happens Mühlemann—or his successor—has a crisis on his hands. Credit Suisse's profits are dismal, its capital ratios are falling, its credit rating is slipping, and staff morale is plunging. In the first quarter, the company made just \$237 million on operating income of \$5.37 billion, barely a quarter of the profit it reported in the same period last year. Archrival UBS, by contrast, rang up a first-quarter profit of \$878 million. For the year, Credit Suisse is expected to earn just \$1.22 billion on

revenue of \$22.48 billion, forecasts do Hoymann of Metzler Bank, a private bank in Frankfurt. That's only a slight improvement on last year's lackluster performance. "Mühlemann's strategy just isn't working," says Hoymann. Indeed, when word started circulating July 1 that he might be forced out, the group's stock rose more than 3%,

to fall back by more than 4% the following day.

The former McKinsey & Co. consultant, who is trying to convince his board members that, given time and a market turn, he can turn the group around successfully merge banking, insurance and investment banking in one group. But nervousness over his stewardship persists. And two possible successors are said to be waiting in the wings. One is Walter B. Kielholz, 51, the chief

**FINANCIAL
EUROPE**

HOT SEAT

Mühlemann addresses investors.
Now, he must reassure the board

a good track again, and we think it has all it takes to be one of the top global players," Mühlemann told *BusinessWeek* in a June 26 interview.

But the problems at Credit Suisse, the world's 11th-largest banking company, go far beyond CSFB. First and foremost, there's Winterthur, the life-and-casualty insurer that Mühlemann bought. Winterthur surprised analysts by reporting a \$140 million loss in the first quarter after its investment income plunged by more than 80%. Falling equity markets in May and June might have cost Winterthur Insurance an additional \$1.1 billion to \$1.5 billion in lost returns, according to Schroder Salomon Smith Barney. That's a double hit because Swiss insurers must guarantee 4% returns to life-insurance policyholders. So on June 20, Mühlemann injected \$1.3 billion of capital into the insurer to bolster its reserves. "They bought Winterthur to balance CSFB and diversify their risk, but it has ended up intensifying it," says Derek Chambers, an analyst who follows the group for HSBC Securities Inc.

Meanwhile, some investors are fretting over the group's shrinking capital base. The group's ratio of equity to total assets had slipped from 12% in 1998 to 9% in the first quarter of this year.

That could drop an additional 50 basis points because of the problems at Winterthur. This level would still be above the 4% legal minimum, but such a slip in a blue-chip institution leaves investors rattled. The shareholder's equity in the \$713-billion-in-assets group has fallen by more than 11%, to \$26 billion, since March of last year.

As if that's not enough, ratings agency Standard & Poor's downgraded the group's long-term debt from AA- to A+ in May, making it more expensive for Credit Suisse to raise money. "We doubt they'll be able to earn decent profits and strengthen their balance sheet in the near term," says Peter Dutton, who follows the bank for S&P.

To be sure, parts of Credit Suisse are doing well. The private-banking business is thriving. So are the corporate and retail operations in Switzer-

land. And while total assets under management dipped slightly, to \$940 billion, in the first quarter, the group is outperforming most rivals on the money-management front. Mühlemann is sure that even Winterthur can be put right. "The underlying performance of the insurance business is good," he insists. "Everyone has problems with their investment portfolio. Ours are just more noticeable because we're the only Swiss insurer that publishes quarterly figures."

There's no denying that Mühlemann has a track record of meeting challenges. Before joining Credit Suisse, he transformed Swiss Re into one of the world's most dynamic financial companies. He steered the group through the Russian crisis of 1998 when CSFB and its clients were the largest holders of Russian Treasury bills and government bonds. And Mühlemann is continuing to cut costs. In Switzerland, for example, he announced plans on June 12 to trim 500 staff by reorganizing the private- and retail-banking operations. "He's capable of putting out these fires," says a board member from a rival bank.

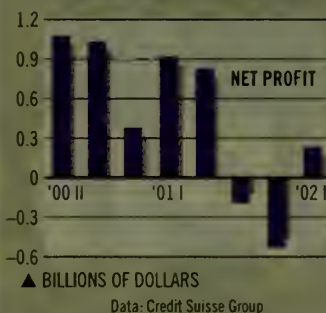
The larger question is whether Mühlemann's strategy will survive. Observers say Credit Suisse seems increasingly likely to dump Winterthur, ending Mühlemann's fling with *bancassurance*—a single institution selling insurance and banking products. This rarely works in practice. Besides, Winterthur isn't big enough to compete effectively with rival insurers, the critics say.

"I'm not convinced that Winterthur belongs to their core business," says Christoph Ritschard, a banking analyst at Zürcher Kantonalbank. Mühlemann doesn't agree. "But no strategy is ever unshakable," he says.

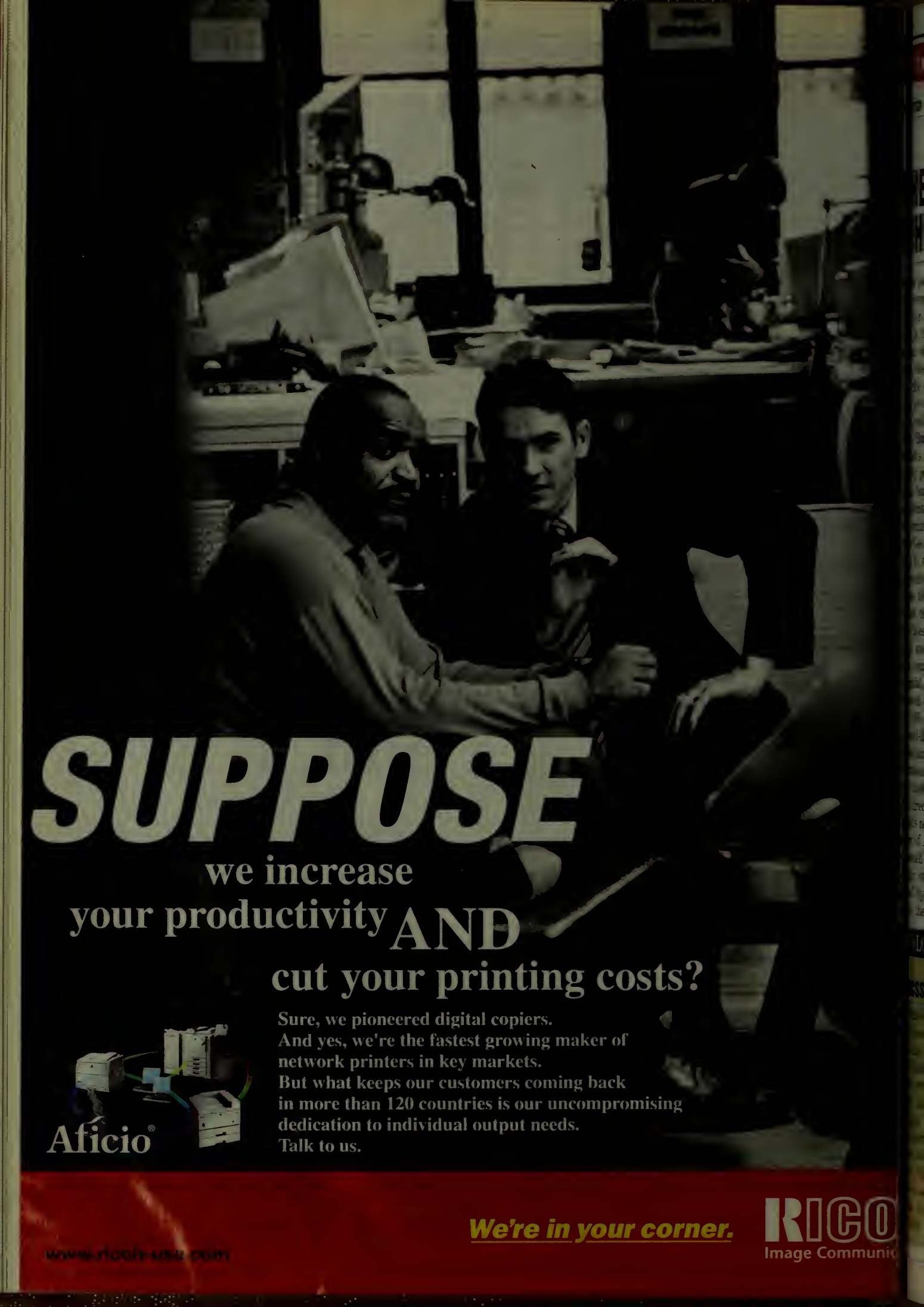
Whatever happens, a speedy recovery for the group looks unlikely. Schroder Salomon Smith Barney analyst Ronit Ghose thinks Credit Suisse was lucky if it made any profit at all in the second quarter, largely because of the deteriorating situation at Winterthur. Unless things improve and fast, institutional investors, which include corporate gadfly Martin Ebner, whose BZ Group Holding has a 7.2% stake, will take their revenge. Swiss banking used to be a dull and predictable business. Investors would love to have some of that boredom back.

By David Fairlamb in Zurich

CREDIT SUISSE'S TUMBLING EARNINGS



...tive of Swiss Re, a reinsurance company and Mühlemann's alma mater. Kielz is also a member of the Credit Suisse board. The other potential replacement is Oswald J. Grubel, 59, the former head of Credit Suisse's successful private-banking operation. Reviving Credit Suisse will not be easy. But supporters say Mühlemann, who became CEO in 1997 and chairman in 2000, has already made a start at Credit Suisse First Boston, the group's money-losing investment-banking operation. There, John J. Mack, the CEO Mühlemann hired last July, has wrung \$5 billion out of its bloated costs. As a result, CSFB narrowed its loss from \$939 million in the final quarter of 2001 to \$100 million in this year's first quarter. It captured top place in the global mergers-and-acquisitions league tables for the first half of the year. "CSFB is on



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THE PALESTINIAN DILEMMA: WHETHER TO JETTISON ARAFAT

For people like Sam Bahour, a 37-year-old telecom entrepreneur, life in the occupied West Bank is getting grimmer. Bahour is afraid to leave his home in Ramallah in the few hours when curfew is lifted because a contingent of Israeli troops have taken over the house across the street. One of their tanks is parked outside. A persistent critic of the disastrous policies of the Palestinian Authority, Bahour nevertheless wonders whether change is possible under the current conditions. "People know there is a need for reform," he says. "But it is a joke when we are locked up in our homes."

What's the reality Palestinians confront as they ponder upcoming elections. Palestinian leader Yassir Arafat has declared legislative and legislative elections for coming January—in response to President George W. Bush's recent call for reform in the Palestinian Authority. The leadership has so far dismissed U.S. demands that they replace Arafat. Nevertheless, the elections could give the 3 million Palestinians who reside in the West Bank and Gaza the chance to debate the course for them really makes sense. Arafat, who hasn't officially declared, is expected to run. The latest polls show him with 35% support—down from the 75% of

in the mid-1990s but ahead of his nearest challenger, says the Palestinian Center for Policy & Survey Research. "Most Palestinians do realize without the [U.S.] President reminding them that Arafat has failed," says Khalil I. Shikaki, the center's director. But most Palestinians "don't want him to go." Arafat's nearest rival, backed by 19%, is Marwan Barghout, a leader of Arafat's Fatah movement who is now languishing in Israeli jail. Elections could also give a bigger voice to the militant organizations Hamas and Islamic Jihad, which are backed by 25% of voters. "There is really no opposition waiting in the wings to take over from Arafat," says Jonathan

Figel, a former Israeli military governor of Ramallah.

If there is to be serious change in Palestinian politics, moderate Arab states will likely be involved. The Egyptians, who have smashed their own Islamic insurgency, may offer the Palestinians help in rounding up suicide bombers. A more crucial contribution from Egypt or Saudi Arabia could be brokering a deal between the U.S. and Arafat that saves the Palestinian chief some face. "If our effort has any chance of success, it has to come from the Saudis and others putting pressure on the Palestinians," says one Administration source.



ARAFAT: Will he be kicked upstairs?

That could involve kicking the Palestinian leader upstairs. One idea making the rounds is to award him a ceremonial role such as the presidency of the Palestinian National Council, which represents Palestinians worldwide, while letting younger leaders run for the post of Prime Minister. "Egypt will not ask Arafat to leave but will not object to a Palestinian alternative to Arafat," says Abdel Moneim Said, director of the Al-Ahram Center for Political and Strategic Studies in Cairo.

The huge setbacks of recent years leave Palestinian society ripe for such changes. But the intense debate needed to shift the leadership is unlikely to happen

as long as Israeli tanks are besieging Palestinian cities. And some analysts wonder whether the U.S. will follow through and recognize a Palestinian state if a leader other than Arafat is elected. "It all depends on the offer. If Arafat steps aside, what do the Palestinians get in return?" asks Emad Shahin, a political science professor at the American University in Cairo. Despite such questions, the Palestinians have few other options than to try and start the painful process of reform.

By Stanley Reed in London and Stan Crock in Washington, with Neal Sandler in Jerusalem and Susan Postlewaite in Cairo

GLOBAL WRAPUP

ERICSSON'S TROUBLED DEAL

Ericsson's new chairman, Michael Johow, has his hands full. The Swedish telecom-equipment maker's \$2 billion share offering appears to be in trouble. Shareholders, who are being asked to buy new stock through a rights offering, are hesitating. With the share price down more than 90% since the March, 2000, peak, investors worry they may be throwing good money after bad. Officials from institutional shareholders such as Alecta, a Swedish pension fund that holds about

3% of the stock, have been publicly speculating that the offering could be canceled if the share price falls below \$1.50. Ericsson shares have tested that floor but bounced back to \$1.65 on July 2, thanks to takeover rumors.

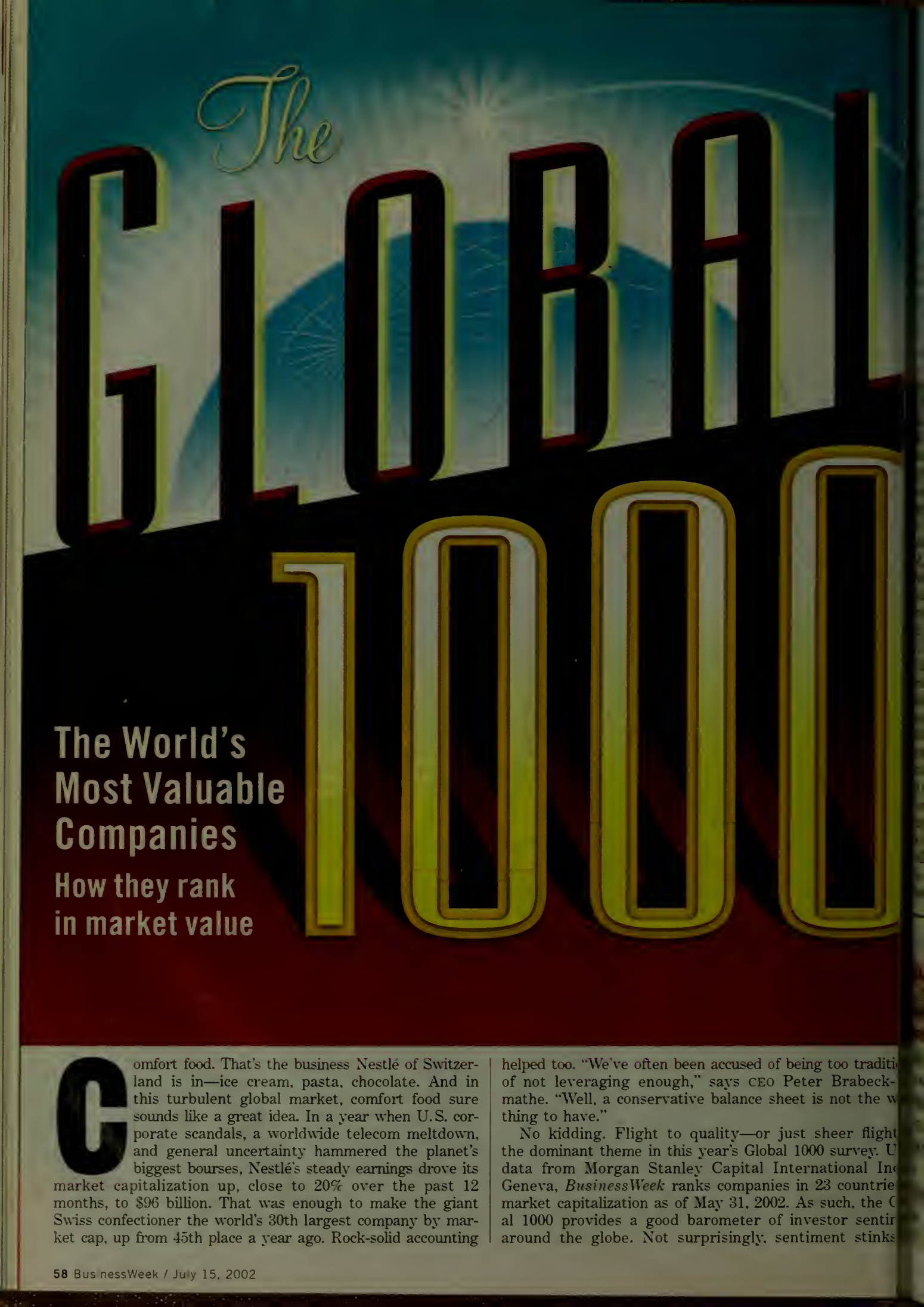
RUSSIAN LAND GRAB?

►Are foreigners getting the shaft as Russia reforms its land code? It may look like it. The country's new land reform law bars foreigners from outright ownership of farmland, instead permitting them only to lease such property. That provision was lobbied for by do-

mestic agribusiness interests who are snapping up choice parcels of land.

"We need a temporary advantage to become as strong as [potential] foreign competitors," says a Moscow agribusiness executive.

Still, determined foreigners should not be too concerned. Similar restrictions on sales of domestic shares of gas giant Gazprom have easily been evaded through gray schemes crafted by lawyers. In the agricultural sector, Russian-registered companies owned by offshore foreign interests are now likely to proliferate, lawyers say.



The GLOBAL 1000

The World's Most Valuable Companies

How they rank in market value

Comfort food. That's the business Nestlé of Switzerland is in—ice cream, pasta, chocolate. And in this turbulent global market, comfort food sure sounds like a great idea. In a year when U.S. corporate scandals, a worldwide telecom meltdown, and general uncertainty hammered the planet's biggest bourses, Nestlé's steady earnings drove its market capitalization up, close to 20% over the past 12 months, to \$96 billion. That was enough to make the giant Swiss confectioner the world's 30th largest company by market cap, up from 45th place a year ago. Rock-solid accounting

helped too. "We've often been accused of being too traditional of not leveraging enough," says CEO Peter Brabeck-Lattemann. "Well, a conservative balance sheet is not the worst thing to have."

No kidding. Flight to quality—or just sheer flight—was the dominant theme in this year's Global 1000 survey. Using data from Morgan Stanley Capital International Inc. in Geneva, *BusinessWeek* ranks companies in 23 countries by market capitalization as of May 31, 2002. As such, the Global 1000 provides a good barometer of investor sentiment around the globe. Not surprisingly, sentiment stinks

Companies that keep it simple are the ones that are getting investors' votes

s, one of the most chaotic years on record, investors either retreated to a few favored stocks or categories, parked their cash in bonds or real estate, or switched funds to hot emerging-market bourses like Korea. The net result was an overall 12% shrinkage of market cap in the exchanges of Japan and the West, to \$18.5 trillion. Even favorites like General Electric, Intel, and Citigroup saw their shares drop. The value of the telecom sector, which dominated the list just two years ago, contracted 34%. A debt overhang from a giant spending spree on fiber-optic networks, 3G licenses, and acquisitions battered the industry. Scandals at WorldCom Communications International Inc. and Global Crossing Ltd. didn't help either.

But even in this *annus horribilis*, size counts—and so, surprisingly, does Americanness. Despite the declining dollar and the steady tom-tom of earnings disappointments and scandalous revelations, American giants dominate the top slots in the Global 1000, with GE, Microsoft, ExxonMobil, Wal-Mart Stores, and Citigroup taking the top five places. U.S. corporations account for more than half the capitalization of our entire list.

True, the rankings are based on end-of-May numbers, which predate the WorldCom Inc. bombshell. But since then, the U.S. stock market has fallen more or less in tandem with the Tokyo and European bourses—which means the general supremacy of U.S. equities still holds true.

What gives? It's simple. Investors who want to stay in developed-country stocks have to keep U.S. shares in their portfolios. And the U.S. economy could still grow 3% or more this year, while Europe will be fortunate to grow at half that rate, and Japan will be lucky to break out of recession. But whether it's American, French, or Japanese stocks, investors are definitely being more discriminating. No longer will they buy into an entire sector. They only want the bluest of the blue chips. Those brave enough to venture back into the market will pick Microsoft Corp. over Oracle Corp. And in telcos, Verizon Communications, with dependable earnings from its long-distance franchise, is favored over AT&T.

One of the few sectors that bucked the trend was consumer staples. The 79 companies that figure in this category registered a combined 19% increase in market cap. Even in a downturn, people have to eat, brush their teeth, and wash their hair. That's good news for stalwarts like Coca-Cola, Colgate-Palmolive, Unilever, and Gillette. And with their strong cash positions, these global marketers can cut deals as well. Nestlé bolstered its bottom line with last year's \$10.3 billion acquisition of pet-food maker Ralston Purina. The Swiss company has pulled even with Anglo-Dutch rival Unilever in ice cream by picking up brands such as Häagen-Dazs and Dreyer's Grand Ice Cream Inc. in the U.S. Nestlé's net profit rose 30% in dollar terms in 2001, to \$4.2 billion, on sales of \$54.1 billion.

The search for steady-as-you-go companies has moved beyond consumer staples to other categories. Thus a reputation for caution has done nothing but good for HSBC Holdings. The London-based international powerhouse ascended

two rungs in our rankings, to No.22. That's impressive considering that pretax profits fell by 18% last year, to \$8 billion, due in large part to HSBC's exposure to Argentina. Still, the company's diversified balance sheet and an emphasis on cost control have stood the bank in good stead. "HSBC's real strength is the conservative position we have always adopted as far as credit is concerned," says group CEO Keith R. Whitson. Other shrewdly managed banks climbed up the rankings too, including another British house, Royal Bank of Scotland Group PLC, which climbed 30 places to No.35. The Edinburgh-based bank is achieving annual savings of \$3 billion a year from its recent merger with NatWest Group.

Oil majors also figure prominently on the list, a reflection of ongoing consolidation within the industry and a largely successful effort by producers to keep prices steady. Last year's merger of note was the \$44 billion tie-up that created Chevron-Texaco Corp. The combination debuts on our list at No.31, while Royal Dutch/Shell Group and BP PLC both stayed in the top 10. Oil companies will continue to post solid earnings in

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How the Giants Stack Up

MARKET VALUE		SALES		PROFITS		SHARE-PRICE GAIN	
BILLIONS OF U.S. DOLLARS		BILLIONS OF U.S. DOLLARS		BILLIONS OF U.S. DOLLARS		% CHANGE FROM 2001 IN U.S. DOLLARS	
GENERAL ELECTRIC	\$309.46	1 WAL-MART STORES	\$217.80	1 EXXON MOBIL	\$15.11	1 AUTOZONE	148%
MICROSOFT	275.70	2 EXXON MOBIL	213.49	2 CITIGROUP	14.28	2 EXPEAIA	138
EXXON MOBIL	271.23	3 GENERAL MOTORS	175.35	3 GENERAL ELECTRIC	14.13	3 AETNA	105
WAL-MART STORES	240.91	4 BP	174.22	4 ROYAL DUTCH/SHELL	10.85	4 MOHAWK INDUSTRIES	105
CITIGROUP	223.04	5 FORO MOTOR	162.41	5 BP	9.88	5 OFFICE DEPOT	100
PFIZER	216.78	6 DAIMLERCHRYSLER	136.07	6 PHILIP MORRIS	8.57	6 MICROCHIP TECHNOLOGY	95
ROYAL DUTCH/SHELL	194.55	7 ROYAL DUTCH/SHELL	135.21	7 PFIZER	7.75	7 SUPERVALU	94
BP	192.12	8 GENERAL ELECTRIC	125.91	8 IBM	7.72	8 PG&E	89
JOHNSON & JOHNSON	186.94	9 TOYOTA MOTOR	121.72	9 MICROSOFT	7.72	9 IMPERIAL TOBACCO	87
INTEL	184.67	10 MITSUBISHI	112.97	10 MERCK	7.28	10 OXFORD HEALTH PLANS	76

Data: Morgan Stanley Capital International, S&P COMPUSTAT

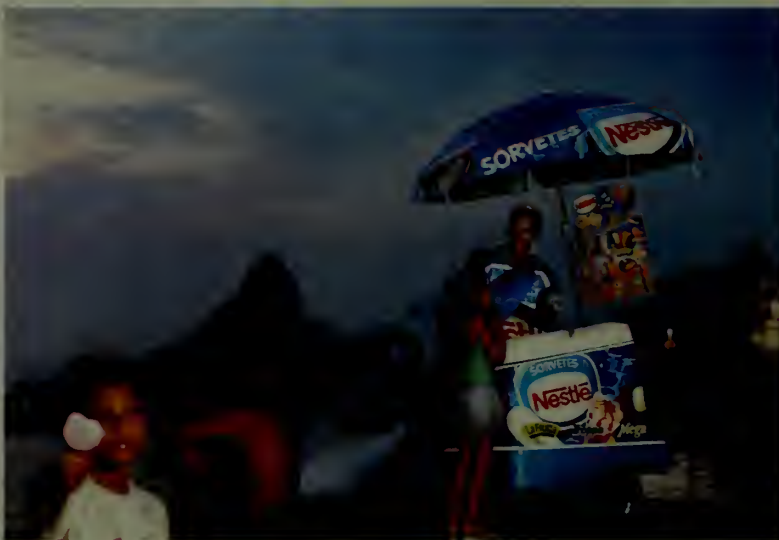
Despite the stream of scandals, American companies continue to dominate the rankings

2002 on a combination of firm oil prices and ongoing cost-cutting.

Pharmaceutical stocks—traditionally seen as safe harbors in choppy markets—have performed poorly in the past year. The main culprits: patent expirations and weak product pipelines. One company that didn't disappoint was Johnson & Johnson. The company soared to No. 9, from 21, largely on the back of blockbusters such as Procrit (sold as Eprex outside the U.S.), an anemia treatment with \$3.4 billion sales last year. The market has clearly endorsed management's move to beef up the prescription drug side of the business through a combination of investment in existing product lines and acquisitions, such as the 1999 purchase of Centocor Inc., a biotech player that sells a fast-growing drug to battle rheumatoid arthritis. "We expect the next couple years to be stronger than typical growth," says Chief Financial Officer Robert J. Darretta. It could still be a rocky road, though: On July 1, U.S. regulators turned down J&J's application with its partner Alkermes Inc. to market a long-acting version of its schizophrenia drug, Risperdal. J&J's shares tumbled on the news.

One big surprise is the strength of the auto sector. Fiat, Italy's deeply troubled carmaker, slid all the way down to No. 658, from 435 the previous year, while Ford slipped from No. 104 to No. 131. But carmakers generally profited from the fact that demand for autos held up surprisingly well in the U.S. General Motors, DaimlerChrysler, Nissan, Honda, and Volkswagen all climbed in the rankings.

Among the carmakers, Honda Motor Co. was one of the few Japanese companies that increased its market cap. It has Americans to thank for it: Three-quarters of the Tokyo-based carmaker's profits come from the U.S. Honda's mainstay sedans are as common a sight in the suburbs of Chicago as they are in the streets of Shanghai. And its family-friendly minivans like the Odyssey and SUVs such as the CR-V are also a big hit with soccer moms—and dads—worldwide. Honda



EDIBLES TO OIL Nestlé's staid accounting helped vault it to No. 30. Consolidation in Big Oil lifted the sector

This year should be better, thanks to the success of movie *Spider-Man* and booming sales of PlayStation consoles and games. If not for the ps2, Sony would have fallen into the red in fiscal 2001.

One fresh threat to Sony's recovery poses a danger for all Japanese exporters. "The strong yen is a problem," says Kun Soo Lee, senior analyst at WestLB Securities Pacific Ltd. in Tokyo. "Sony bases its calculations on an exchange rate of 130 yen to the dollar, but it's already down under 120 and may soon be 110 yen." Other Japanese companies dependent on the U.S. market, including Matsushita Electric Industrial Co., the carmakers, and specialty tech companies like Rohm Co. and NEC Corp. could face a similar hammering from a stronger yen.

Overall, it's a bleak picture for the markets. So bleak that maybe it's time for a frosty one. Investors think so: They moved the world's biggest brewer, Anheuser-Busch Companies Inc., to No. 80 in our rankings, from 120. Its market cap rose 15%, to \$45 billion. With almost half the U.S. beer market, the St. Louis-based brewer boasts enviable pricing power and huge leverage with distributors. Anheuser-Busch registered a 10% increase in net income, to \$1.7 billion, on sales of \$12.9 billion in 2001. And the balance sheet looks surprise-free. "Our business is really fairly simple," says newly installed CEO Patrick T. Stokes, who took over from August A. Busch III on July 1. That's right: You brew beer, you sell it. In this addled market, the simpler the better.

By Cristina Lindblad in New York, with bureau reports

BusinessWeek online

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Special Report

CEO to-do list

- ☐ The impossible
- ☐ The unpredictable
- ☐ The right thing
- ☐ The next thing
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The BusinessWeek Global 1000

MARKET VALUE: Share price on May 31, 2002, multiplied by latest available number of shares outstanding, translated into U.S. dollars. May month-end exchange rates. Market value may include several classes of stock; prices based on the company's most widely held issue. Data for individual companies: Morgan Stanley Capital International Inc., unless otherwise indicated. For further information on MSCI data, contact Morgan Stanley at 212-762-3400 (New York) or 44 20 7425 6660 (London) or 41 22 817 9000 (Geneva). Rankings calculated by *BusinessWeek*. Additional data provided by Standard & Poor's COMPUSTAT, if footnoted.

RANK			MARKET VALUE			RANK			MARKET VAL	
2002	2001		Billions of U.S. dollars			2002	2001		B	
1	1	GENERAL ELECTRIC	U.S.	309.46		46	62	DELL COMPUTER	U.S.	69
2	2	MICROSOFT	U.S.	275.70		47	57	UBS	Switzerland	69
3	3	EXXON MOBIL	U.S.	271.23		48	20	NOKIA	Finland	67
4	6	WAL-MART STORES (7)	U.S.	240.91		49	55	UNITED PARCEL SERVICE (7)	U.S.	61
5	5	CITIGROUP (7)	U.S.	223.04		50	79	UNILEVER	Neth./Britain	64
6	4	PFIZER	U.S.	216.78		51	47	BELLSOUTH (7)	U.S.	62
7	8	ROYAL DUTCH/SHELL GROUP	Neth./Britain	194.55		52	84	ENI	Italy	60
8	9	BP	Britain	192.12		53	29	BRISTOL-MYERS SQUIBB (7)	U.S.	60
9	21	JOHNSON & JOHNSON	U.S.	186.94		54	75	LLOYDS TSB GROUP	Britain	60
10	13	INTEL	U.S.	184.67		55	72	HEWLETT-PACKARD (7)	U.S.	57
11	12	AMERICAN INTERNATIONAL GROUP (7)	U.S.	174.99		56	85	BARCLAYS	Britain	57
12	23	COCA-COLA	U.S.	138.00		57	73	AMERICAN EXPRESS	U.S.	57
13	10	INTERNATIONAL BUSINESS MACHINES	U.S.	137.72		58	64	PHARMACIA	U.S.	56
14	11	NTT DOCOMO	Japan	135.86		59	82	MEOTRONIC (7)	U.S.	56
15	16	MERCK	U.S.	129.68		60	71	AVENTIS	France	55
16	15	GLAXOSMITHKLINE	Britain	126.27		61	61	SIEMENS	Germany	54
17	27	NOVARTIS	Switzerland	123.93		62	53	ALLIANZ	Germany	54
18	26	PHILIP MORRIS	U.S.	122.93		63	49	SONY	Japan	53
19	36	BANK OF AMERICA	U.S.	117.09		64	67	TELECOM ITALIA	Italy	53
20	17	VERIZON COMMUNICATIONS	U.S.	116.84		65	60	ING GROEP	Netherlands	52
21	39	PROCTER & GAMBLE	U.S.	116.38		66	154	WACHOVIA (7)	U.S.	51
22	24	HSBC HOLDINGS	Britain	116.34		67	54	TELEFONICA	Spain	51
23	19	CISCO SYSTEMS (7)	U.S.	115.53		68	48	MORGAN STANLEY	U.S.	50
24	18	SBC COMMUNICATIONS (7)	U.S.	114.53		69	124	BNP PARIBAS	France	49
25	30	BERKSHIRE HATHAWAY (7)	U.S.	114.36		70	52	AMGEN	U.S.	49
26	28	TOTALFINAELF	France	110.51		71	70	TEXAS INSTRUMENTS	U.S.	49
27	14	VODAFONE GROUP	Britain	102.95		72	97	DAIMLERCHRYSLER	Germany	49
28	22	TOYOTA MOTOR	Japan	99.70		73	93	3M	U.S.	48
29	25	HOME DEPOT	U.S.	97.97		74	106	L'OREAL	France	48
30	45	NESTLE	Switzerland	96.16		75	98	BANC ONE	U.S.	47
31	66	CHEVRONTXACO (7)	U.S.	93.14		76	58	WALT DISNEY	U.S.	46
32	59	PEPSICO	U.S.	91.90		77	37	DEUTSCHE TELEKOM	Germany	46
33	44	WELLS FARGO	U.S.	89.64		78	90	DUPONT	U.S.	45
34	31	VIACOM	U.S.	87.25		79	100	FREDDIE MAC	U.S.	45
35	65	ROYAL BANK OF SCOTLAND GROUP	Britain	83.40		80	120	ANHEUSER-BUSCH	U.S.	45
36	7	AOL TIME WARNER	U.S.	82.78		81	110	U.S. BANCORP	U.S.	45
37	42	FANNIE MAE	U.S.	79.65		82	NR	HBOS	Britain	45
38	40	ASTRAZENECA	Britain	76.65		83	92	DEUTSCHE BANK	Germany	44
39	NR	KRAFT FOODS (7)	U.S.	74.62		84	78	MITSUBISHI TOKYO FINANCIAL GROUP	Japan	44
40	46	ABBOTT LABORATORIES	U.S.	74.13		85	103	SANOFI-SYNTHELABO	France	44
41	33	NIPPON TELEGRAPH & TELEPHONE	Japan	73.71		86	76	CREDIT SUISSE GROUP	Switzerland	44
42	41	WYETH (7)	U.S.	73.64		87	109	BANCO SANTANDER CENTRAL HISPANO	Spain	44
43	56	ROCHE HOLDING	Switzerland	73.34		88	38	ORACLE	U.S.	43
44	35	ELI LILLY	U.S.	72.72		89	32	TYCO INTERNATIONAL	U.S.	43
45	34	J.P. MORGAN CHASE (7)	U.S.	71.55		90	43	AT&T	U.S.	42

1) Global ranking calculated for Royal Dutch/Shell Group by combining market value of the Netherlands' Royal Dutch Petroleum and Britain's Shell Transport & Trading. 2) Global ranking calculated for Unilever by combining market value of the Netherlands' Unilever NV and Britain's Unilever PLC. 3) Global ranking calculated for BHP Billiton by combining market value of Britain's BHP Billiton PLC and Australia's BHP Billiton LTD. 4) Global ranking calculated for Rio Tinto by combining market value of Britain's Rio Tinto PLC and Australia's Rio Tinto LTD. 5) Global ranking calculated for Reed Elsevier by combining market value of Britain's Reed Elsevier PLC and the Netherlands' Reed Elsevier NV. 6) Global ranking calculated for Brambles Industries by combining market value of Britain's Brambles Industries PLC and the Australia's Brambles Industries LTD. 7) Data for this company provided by Standard & Poor's COMPUSTAT. NR=Not ranked.

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It's not how many ideas you have. It's how many you make happen.



As the global leader in enterprise information storage solutions, EMC recognized that a complete overhaul of its existing business system was needed to sustain future growth. **I am EMC's idea, delivered.** Accenture teamed with EMC to design and build a massive, scalable information infrastructure to integrate all of EMC's systems and processes globally, accelerate new product introductions and give management more flexibility in responding to changing market conditions. Now, design changes can make the rounds to 6,000 users around the world in minutes, instead of days.



In the last three years, Wyeth has launched nine new products and three of these have been among the most successful prescription medication launches of all time. Wyeth wanted to ensure that its R&D organization would continue to fuel this pace of innovation for patients worldwide. **I am Wyeth's idea, delivered.** Accenture helped Wyeth refine their management and decision-making processes, implement innovative changes to Discovery, and instill a culture of performance management and accountability—all with the goal of producing ten to twelve new development candidates a year. Productivity is now up significantly and Wyeth ranks among the industry leaders in cost, output and cycle time.



As the agency that oversees nearly a million people and businesses licensed by the state—from real-estate agents, barbers and CPAs to restaurants and hotels—the Florida Department of Business and Professional Regulation (DBPR) wanted to develop an Internet portal and an automated phone service to make the licensing process dramatically easier. **I am the State of Florida's idea, delivered.** Accenture was chosen to overhaul the department's business processes and technology and to implement a first-of-its-kind online licensing system. Being phased in over 24 months, the new system is estimated to save the state of Florida between \$70 million and \$100 million in its first ten years.

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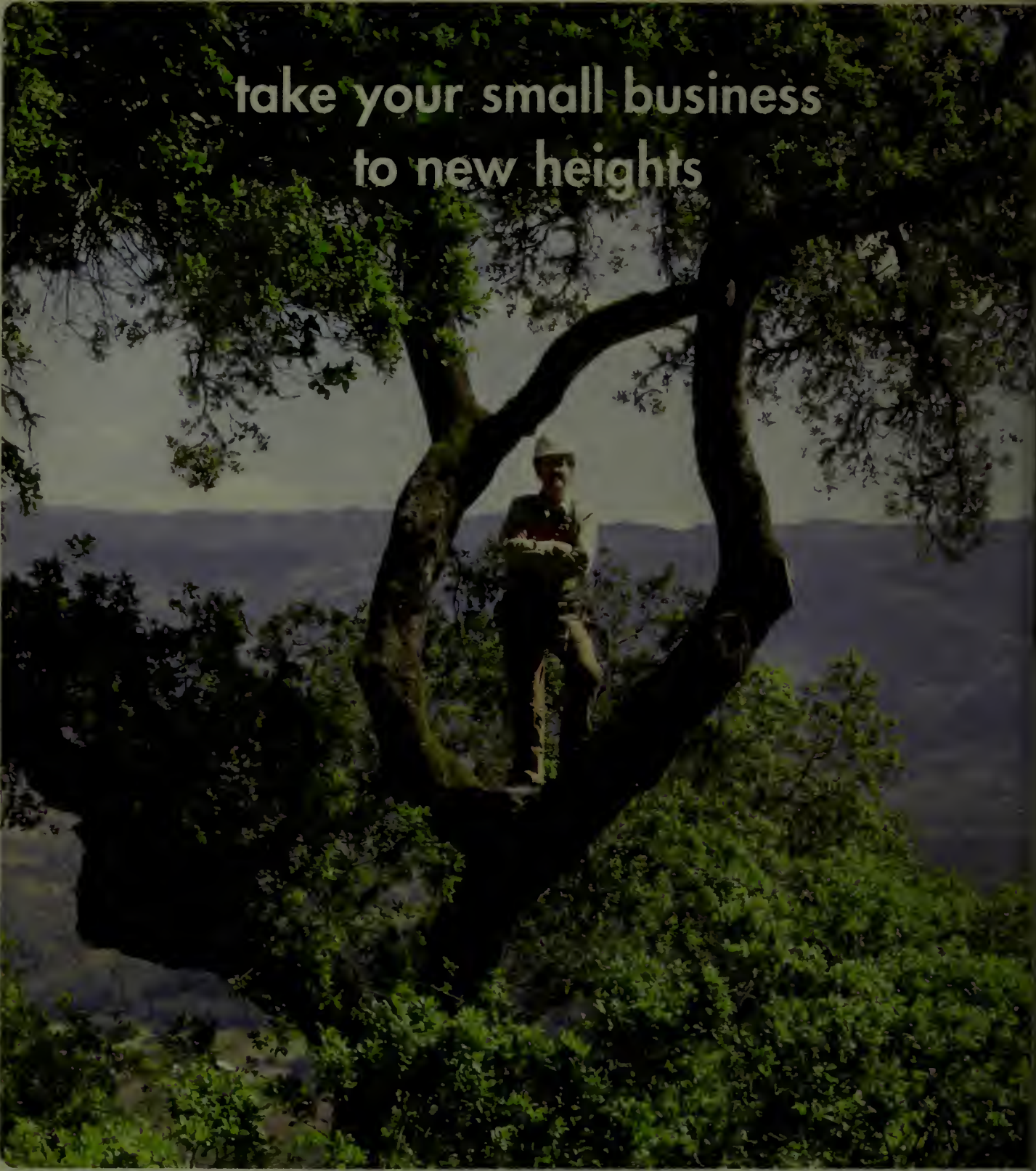
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Innovation delivered

The BusinessWeek Global 1000

RANK		MARKET VALUE		RANK		MARKET VALUE			
2001		Billions of U.S. dollars		2002 2001		Billions of U.S. dollars			
1	133	DIAGEO	Britain	41.75	156	252	UNITEOHEALTH GROUP	U.S.	27.96
2	114	HONDA MOTOR	Japan	41.61	157	281	LOCKHEED MARTIN (7)	U.S.	27.80
3	89	MUNCHENER RUECK.	Germany	41.39	158	168	MARSH & McLENNAN	U.S.	27.40
4	140	ROYAL PHILIPS ELECTRONICS	Netherlands	40.99	159	147	ALLSTATE	U.S.	27.30
5	101	TAKEO A CHEMICAL INDUSTRIES	Japan	40.06	160	164	TELEFONICA MOVILES	Spain	26.77
6	115	WALGREEN	U.S.	39.16	161	113	ORANGE	France	26.76
7	68	SCHERING-PLOUGH	U.S.	38.78	162	180	RIO TINTO	Australia/Brit.	26.47
8	107	BANCO BILBAO VIZCAYA ARGENTARIA	Spain	38.55	163	117	BANK OF NEW YORK (7)	U.S.	26.43
9	119	MCDONALD'S	U.S.	38.08	164	201	TESCO	Britain	26.41
10	145	FIFTH THIRD BANCORP	U.S.	37.93	165	139	DUKE ENERGY	U.S.	26.41
1	155	WASHINGTON MUTUAL	U.S.	37.84	166	280	BRITISH AMERICAN TOBACCO	Britain	26.13
2	162	GILLETTE (7)	U.S.	37.60	167	174	LVMH MOET HENNESSY LOUIS VUITTON	France	25.97
3	146	TARGET	U.S.	37.59	168	241	ROYAL BANK OF CANADA	Canada	25.85
4	102	FLEETBOSTON FINANCIAL	U.S.	36.88	169	134	COMCAST	U.S.	25.31
5	183	LOWE'S	U.S.	36.63	170	172	ELECTRONIC DATA SYSTEMS	U.S.	25.30
6	99	GOLOMAN SACHS GROUP	U.S.	36.34	171	143	HITACHI LTD.	Japan	25.29
7	116	APPLIED MATERIALS	U.S.	36.33	172	231	KOHL'S	U.S.	25.21
8	151	MOTOROLA	U.S.	36.30	173	224	HCA	U.S.	25.02
9	86	TIM	Italy	36.25	174	153	STMICROELECTRONICS	France	24.76
10	127	ENEL	Italy	36.14	175	95	QUALCOMM (7)	U.S.	24.35
1	131	E.ON	Germany	36.06	176	167	EMERSON ELECTRIC	U.S.	24.34
2	NR	BHP BILLITON	Australia/Brit.	35.86	177	321	TENET HEALTHCARE	U.S.	24.28
3	125	CARREFOUR	France	35.84	178	240	COMMONWEALTH BANK OF AUSTRALIA	Australia	23.76
4	129	SEVEN-ELEVEN JAPAN	Japan	35.81	179	170	BAYER	Germany	23.74
5	96	HUTCHISON WHAMPOA	Hong Kong	35.67	180	203	METLIFE	U.S.	23.44
6	81	BT GROUP	Britain	35.55	181	163	HOUSEHOLD INTERNATIONAL	U.S.	23.35
7	77	MERRILL LYNCH (7)	U.S.	35.02	182	211	UNICREDITO ITALIANO	Italy	22.94
8	156	GENERAL MOTORS (7)	U.S.	34.84	183	94	MIZUHO HOLDINGS	Japan	22.70
9	112	TELSTRA	Australia	34.45	184	63	FRANCE TELECOM	France	22.39
10	128	NEWS CORP.	Australia	34.33	185	80	SUN MICROSYSTEMS (7)	U.S.	22.37
1	50	VIVENDI UNIVERSAL	France	34.14	186	213	ITO-YOKAIDO	Japan	22.27
2	74	BOEING (7)	U.S.	34.07	187	237	REED ELSEVIER	Neth./Britain	22.19
3	88	AXA	France	33.87	188	282	PHILLIPS PETROLEUM	U.S.	21.94
4	141	CANON	Japan	33.77	189	199	ABBAY NATIONAL	Britain	21.89
5	149	KIMBERLY-CLARK	U.S.	33.69	190	NR	CREDIT AGRICOLE	France	21.87
6	105	SAP	Germany	32.97	191	227	ILLINOIS TOOL WORKS	U.S.	21.75
7	123	UNITED TECHNOLOGIES	U.S.	32.58	192	728	AT&T WIRELESS SERVICES	U.S.	21.71
8	166	BAXTER INTERNATIONAL (7)	U.S.	32.27	193	225	RWE	Germany	21.52
9	144	AUTOMATIC DATA PROCESSING	U.S.	32.20	194	192	CHEUNG KONG HOLDINGS	Hong Kong	21.45
10	179	NISSAN MOTOR	Japan	32.07	195	248	FOX ENTERTAINMENT GROUP	U.S.	21.28
1	126	HONEYWELL INTERNATIONAL	U.S.	32.05	196	223	HANG SENG BANK	Hong Kong	21.14
2	104	FORD MOTOR (7)	U.S.	31.99	197	165	CGNU	Britain	21.09
3	91	SUMITOMO MITSUI BANKING	Japan	31.97	198	253	INTERNATIONAL PAPER	U.S.	20.81
4	137	CLEAR CHANNEL COMMUNICATIONS	U.S.	31.91	199	220	THOMSON	Canada	20.69
5	194	NATIONAL AUSTRALIA BANK	Australia	31.86	200	251	VOLKSWAGEN	Germany	20.61
6	121	NOMURA HOLDINGS	Japan	31.68	201	249	BRITISH SKY BROADCASTING GROUP	Britain	20.35
7	175	SWISS RE	Switzerland	31.53	202	304	GENERAL DYNAMICS	U.S.	20.25
8	108	LIBERTY MEDIA	U.S.	31.03	203	262	NATIONAL CITY	U.S.	20.25
9	169	MBNA	U.S.	30.84	204	198	COX COMMUNICATIONS	U.S.	20.20
10	136	AEGON	Netherlands	30.56	205	268	GANNETT	U.S.	20.20
1	150	DOW CHEMICAL	U.S.	30.26	206	NR	PRUDENTIAL FINANCIAL	U.S.	20.15
2	189	FIRST DATA	U.S.	30.19	207	197	KONINKLIJKE AHOLO	Netherlands	19.71
3	152	CARDINAL HEALTH (7)	U.S.	30.02	208	195	SAFeway (7)	U.S.	19.69
4	171	ABN AMRO HOLDING	Netherlands	29.81	209	176	NINTENDO	Japan	19.59
5	135	SCHLUMBERGER (7)	U.S.	29.80	210	256	SUNTRUST BANKS	U.S.	19.55
6	138	ASSICURAZIONI GENERALI	Italy	29.79	211	243	GROUPE DANONE	France	19.49
7	148	COLGATE-PALMOLIVE (7)	U.S.	29.65	212	173	ZURICH FINANCIAL SERVICES GROUP	Switzerland	19.46
8	132	ALCOA	U.S.	29.62	213	208	PRUDENTIAL	Britain	19.45
9	157	FORTIS	Belgium	29.43	214	NR	ACCENTURE (7)	U.S.	19.39
10	158	SUEZ	France	29.04	215	205	INTESABCI	Italy	19.28
1	130	MATSUSHITA ELECTRIC INDUSTRIAL	Japan	28.99	216	295	SOUTHERN CO.	U.S.	18.99
2	193	SOCIETE GENERALE	France	28.84	217	NR	HUGHES ELECTRONICS (7)	U.S.	18.97
3	207	BMW	Germany	28.79	218	260	SWISSCOM	Switzerland	18.97
4	142	TOKYO ELECTRIC POWER	Japan	28.34	219	289	CENOANT (7)	U.S.	18.97
5	196	BASF	Germany	28.20	220	NR	STATOIL	Norway	18.86



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Jeff and Lake Kowell operate Image Tree Service. Jeff works on the trees, Lake runs the business. Jeff doesn't just trim trees, he shapes them to complement and enhance homes and workplaces. He's an artist. That makes Image Tree Service different from most – an excellent selling point. But Jeff and Lake are so busy working, they don't have time to think about Image Tree's image. Irony? Not to Jeff and Lake.

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H01

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The BusinessWeek Global 1000

RANK			MARKET VALUE			RANK			MARKET VALUE	
2002	2001		Billions of U.S. dollars			2002	2001		Billions of U.S. d	
221	209	SUN HUNG KAI PROPERTIES	Hong Kong	18.85	286	190	FUJITSU	Japan	14	
222	204	EAST JAPAN RAILWAY	Japan	18.73	287	433	BEST BUY	U.S.	14	
223	185	GENENTECH	U.S.	18.66	288	408	CREOIT LYONNAIS	France	14	
224	188	HYPOVEREINSBANK	Germany	18.60	289	161	ALCATEL	France	14	
225	360	SEARS, ROEBUCK	U.S.	18.59	290	261	LEHMAN BROTHERS HOLOINGS	U.S.	14	
226	326	OEXIA	Belgium	18.54	291	181	UFJ HOLOINGS	Japan	14	
227	239	SYSCO	U.S.	18.52	292	380	WEYERHAEUSER (7)	U.S.	14	
228	331	BANK OF NOVA SCOTIA	Canada	18.13	293	428	NIKE	U.S.	14	
229	316	BB&T (7)	U.S.	18.08	294	294	SHARP	Japan	14	
230	87	LM ERICSSON	Sweden	18.05	295	215	REPSOL YPF	Spain	14	
231	250	CATERPILLAR (7)	U.S.	17.98	296	370	MANULIFE FINANCIAL	Canada	14	
232	271	COSTCO WHOLESALE	U.S.	17.83	297	412	ALBERTSON'S (7)	U.S.	14	
233	283	CARNIVAL	U.S.	17.83	298	519	SUN LIFE FINANCIAL SERVICES OF CANAOA	Canada	14	
234	285	DOMINION RESOURCES	U.S.	17.80	299	347	RICOH	Japan	14	
235	233	KROGER (7)	U.S.	17.77	300	310	H.J. HEINZ	U.S.	14	
236	453	RAYTHEON	U.S.	17.60	301	210	MICRON TECHNOLOGY	U.S.	14	
237	NR	TRAVELERS PROPERTY CASUALTY (7)	U.S.	17.55	302	379	L'AIR LIQUIOE	France	14	
238	222	ROHM	Japan	17.48	303	299	KAO	Japan	14	
239	216	EXELON	U.S.	17.22	304	286	COMPASS GROUP	Britain	13	
240	279	NOROE	Sweden	17.15	305	559	IMMUNEX	U.S.	13	
241	313	BAE SYSTEMS	Britain	17.15	306	426	RENAULT	France	13	
242	287	SHIN-ETSU CHEMICAL	Japan	17.02	307	277	KANSAI ELECTRIC POWER	Japan	13	
243	270	WASTE MANAGEMENT	U.S.	16.97	308	293	AMERICAN ELECTRIC POWER	U.S.	13	
244	245	MURATA MFG.	Japan	16.95	309	319	CENTRAL JAPAN RAILWAY	Japan	13	
245	302	HEINEKEN	Netherlands	16.85	310	356	CAPITAL ONE FINANCIAL (7)	U.S.	13	
246	244	CONOCO (7)	U.S.	16.84	311	339	COMPAGNIE FINANCIERE RICHEMONT	Switzerland	13	
247	399	GENERAL MILLS (7)	U.S.	16.66	312	630	NORTHROP GRUMMAN	U.S.	13	
248	273	AFLAC	U.S.	16.65	313	367	PEUGEOT	France	13	
249	187	CHARLES SCHWAB	U.S.	16.58	314	160	EL PASO	U.S.	13	
250	315	SARA LEE	U.S.	16.54	315	376	TXU	U.S.	13	
251	416	AUSTRALIA & NEW ZEALAND BANKING GROUP	Australia	16.51	316	263	OENSO	Japan	13	
252	394	WESTPAC BANKING	Australia	16.50	317	254	TOSHIBA	Japan	13	
253	272	ENOESA	Spain	16.42	318	338	JAPAN TOBACCO	Japan	13	
254	214	MELLON FINANCIAL	U.S.	16.36	319	247	SAN PAOLO-IMI	Italy	13	
255	298	HARTFORD FINANCIAL SERVICES GROUP	U.S.	16.33	320	402	DANSKE BANK	Denmark	13	
256	291	TORONTO-DOMINION BANK	Canada	16.23	321	429	NORSK HYORO	Norway	13	
257	217	FUJI PHOTO FILM	Japan	16.17	322	305	STANOARO CHARTEREO	Britain	13	
258	275	OMNICOM GROUP (7)	U.S.	16.16	323	297	ANALOG OEVICES	U.S.	13	
259	276	DEUTSCHE POST	Germany	16.14	324	274	NTT DATA	Japan	13	
260	51	EMC	U.S.	16.12	325	401	LAFARGE	France	13	
261	406	FEDEX	U.S.	16.10	326	427	CONAGRA FOODS	U.S.	13	
262	NR	MILLEA HOLOINGS	Japan	16.01	327	368	FOREST LABORATORIES (7)	U.S.	13	
263	257	ALLTEL	U.S.	16.00	328	301	EAOS	France	13	
264	389	CONCORD EFS (7)	U.S.	15.97	329	457	STORA ENSO	Finland	13	
265	235	PNC FINANCIAL SERVICES GROUP	U.S.	15.94	330	497	PROGRESSIVE (7)	U.S.	13	
266	182	LUCENT TECHNOLOGIES (7)	U.S.	15.93	331	450	INTERBREW	Belgium	13	
267	334	HARLEY-DAVIOSON	U.S.	15.91	332	309	SOUTHWEST AIRLINES	U.S.	13	
268	332	SINGAPORE TELECOMMUNICATIONS	Singapore	15.66	333	405	NATIONAL GRID GROUP	Britain	13	
269	259	SPRINT FON GROUP (7)	U.S.	15.48	334	330	PAYCHEX	U.S.	13	
270	288	EBAY	U.S.	15.47	335	500	BANK OF IRELAND	Ireland	12	
271	362	HENNES & MAURITZ	Sweden	15.38	336	706	UNITED OVERSEAS BANK	Singapore	12	
272	264	KYOCERA	Japan	15.35	337	490	INOITEX	Spain	12	
273	354	BG GROUP	Britain	15.32	338	439	WM. WRIGLEY JR. (7)	U.S.	12	
274	377	COMPAGNIE DE SAINT-GOBAIN	France	15.30	339	387	AKZO NOBEL	Netherlands	12	
275	333	UNION PACIFIC	U.S.	15.21	340	442	MASCO	U.S.	12	
276	229	PIAULT-PRINTEMPS-REOOUTE	France	15.13	341	365	CHUBB (7)	U.S.	12	
277	265	STATE STREET	U.S.	15.11	342	343	CENTRICA	Britain	12	
278	228	KOOI	Japan	15.10	343	469	MARKS & SPENCER GROUP	Britain	12	
279	366	CAOBURY SCHWEPES	Britain	15.02	344	373	TRIBUNE	U.S.	12	
280	438	KELLOGG	U.S.	15.01	345	303	ANADARKO PETROLEUM	U.S.	12	
281	230	BCE (BELL CANADA ENTERPRISES)	Canada	15.00	346	184	GAP	U.S.	12	
282	323	MAXIM INTEGRATED PROOUCTS	U.S.	14.99	347	335	CHUBU ELECTRIC POWER	Japan	12	
283	418	SLM	U.S.	14.99	348	417	INTERPUBLIC GROUP (7)	U.S.	12	
284	327	CIGNA (7)	U.S.	14.94	349	219	CVS (7)	U.S.	12	
285	591	ENCANA	Canada	14.68	350	411	IBEROROLA	Spain	12	



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The BusinessWeek Global 1000

RANK			MARKET VALUE			RANK			MARKET VALUE		
2002	2001		Billions of U.S. dollars			2002	2001		Billions of U.S. dollars		
351	531	EQUITY OFFICE PROPERTIES TRUST	U.S.	12.54		416	420	AMP LTD.	Australia	10	
352	460	AVON PRODUCTS	U.S.	12.53		417	393	JOHN HANCOCK FINANCIAL SERVICES	U.S.	10	
353	226	BOMBARDIER	Canada	12.53		418	218	ABB	Switzerland	10	
354	522	BRIDGESTONE	Japan	12.51		419	424	STRYKER	U.S.	10	
355	372	FANUC	Japan	12.39		420	486	McKESSON (7)	U.S.	10	
356	795	IMPERIAL TOBACCO GROUP	Britain	12.38		421	404	J. SAINSBURY	Britain	10	
357	336	ALCAN	Canada	12.37		422	824	WELLPOINT HEALTH NETWORKS	U.S.	10	
358	364	BAKER HUGHES (7)	U.S.	12.36		423	643	GEORGE WESTON	Canada	10	
359	495	ALLIED IRISH BANKS	Ireland	12.35		424	381	METRO	Germany	10	
360	510	SCHNEIDER ELECTRIC	France	12.35		425	234	SPRINT PCS GROUP (7)	U.S.	10	
361	178	NEC	Japan	12.34		426	586	CLOROX (7)	U.S.	10	
362	383	McGRAW-HILL (7)	U.S.	12.27		427	462	OAI NIPPON PRINTING	Japan	10	
363	386	CANADIAN IMPERIAL BANK OF COMMERCE	Canada	12.26		428	532	ORANIER	U.S.	10	
364	413	GUIDANT	U.S.	12.24		429	458	MITSUI & CO.	Japan	10	
365	NR	NEWMONT MINING	U.S.	12.23		430	374	JAPAN TELECOM	Japan	10	
366	306	AGILENT TECHNOLOGIES	U.S.	12.23		431	358	OLIVETTI	Italy	10	
367	363	BANK OF MONTREAL	Canada	12.20		432	400	MITSUBISHI ELECTRIC	Japan	10	
368	451	AOECCO	Switzerland	12.20		433	687	FIRSTENERGY (7)	U.S.	10	
369	278	TRANSOCEAN	U.S.	12.18		434	516	GUCCI GROUP	Netherlands	10	
370	456	OBS GROUP HOLDINGS	Singapore	12.14		435	391	BOUYGUES	France	10	
371	221	INFINEON TECHNOLOGIES	Germany	12.09		436	605	UPM-KYMMENE	Finland	10	
372	325	ECHOSTAR COMMUNICATIONS (7)	U.S.	12.09		437	489	MAY DEPARTMENT STORES	U.S.	10	
373	465	SCHERING	Germany	12.05		438	403	ACOM	Japan	10	
374	449	ELECTRABEL	Belgium	12.04		439	369	TAKEFUJI	Japan	10	
375	392	WPP GROUP	Britain	12.03		440	284	COMPUTER ASSOCIATES INTERNATIONAL (7)	U.S.	10	
376	481	XL CAPITAL	U.S.	12.00		441	568	BEY BATH & BEYOND	U.S.	9	
377	353	SECOM	Japan	11.97		442	538	CASTORAMA OUBOIS INVESTISSEMENTS	France	9	
378	385	MITSUBISHI CORP.	Japan	11.97		443	355	COMMERZBANK	Germany	9	
379	448	IMPERIAL OIL	Canada	11.89		444	314	PEARSON	Britain	9	
380	397	TOKYO ELECTRON	Japan	11.86		445	593	BEIERSDOORF	Germany	9	
381	351	XILINX	U.S.	11.83		446	571	HENKEL	Germany	9	
382	329	MITSUBISHI HEAVY INDUSTRIES	Japan	11.82		447	505	ENTERGY	U.S.	9	
383	307	LINEAR TECHNOLOGY	U.S.	11.82		448	723	STAPLES (7)	U.S.	9	
384	502	USA INTERACTIVE (7)	U.S.	11.78		449	487	PITNEY BOWES	U.S.	9	
385	734	BARRICK GOLD	Canada	11.74		450	447	YAMANOUCHI PHARMACEUTICAL	Japan	9	
386	388	T-ONLINE INTERNATIONAL	Germany	11.66		451	603	SHELL CANADA	Canada	9	
387	473	KEYCORP	U.S.	11.61		452	419	MARRIOTT INTERNATIONAL (7)	U.S.	9	
388	398	CAMPBELL SOUP (7)	U.S.	11.55		453	463	CLP HOLDINGS	Hong Kong	9	
389	384	MITSUBISHI ESTATE	Japan	11.52		454	554	HOLCIM	Switzerland	9	
390	493	TIJX	U.S.	11.50		455	648	POWER FINANCIAL	Canada	9	
391	318	NORTHERN TRUST	U.S.	11.49		456	324	OAIWA SECURITIES GROUP	Japan	9	
392	440	KBC BANCASSURANCE HOLDING	Belgium	11.48		457	446	TPG	Netherlands	9	
393	425	LEGAL & GENERAL GROUP	Britain	11.41		458	238	REUTERS GROUP	Britain	9	
394	534	LOBLAW	Canada	11.40		459	545	BECTON, DICKINSON	U.S.	9	
395	437	FRANKLIN RESOURCES (7)	U.S.	11.40		460	677	COCA-COLA ENTERPRISES (7)	U.S.	9	
396	544	PROGRESS ENERGY (7)	U.S.	11.34		461	346	EASTMAN KODAK	U.S.	9	
397	308	NOVO-NORDISK	Denmark	11.33		462	491	SIX CONTINENTS	Britain	9	
398	680	BOSTON SCIENTIFIC (7)	U.S.	11.31		463	499	KLA-TENCOR	U.S.	9	
399	470	COMERICA (7)	U.S.	11.28		464	628	CANADIAN NATIONAL RAILWAY	Canada	9	
400	573	RECKITT BENCKISER	Britain	11.24		465	513	PPG INDUSTRIES	U.S.	9	
401	431	OCCIDENTAL PETROLEUM	U.S.	11.19		466	657	CONCESSIONI E COSTRUZIONI AUTOSTRADE	Italy	9	
402	543	DEERE (7)	U.S.	11.17		467	647	AEON	Japan	9	
403	483	SVENSKA HANDELSBANKEN	Sweden	11.14		468	530	BAA	Britain	9	
404	467	FPL GROUP	U.S.	11.08		469	466	YAHOO!	U.S.	9	
405	422	NIPPON STEEL	Japan	11.08		470	567	GUS	Britain	9	
406	311	NIKKO COROIAL	Japan	11.07		471	666	BANCO POPULAR ESPANOL	Spain	9	
407	317	VIVENDI ENVIRONNEMENT	France	10.97		472	558	ARCHER DANIELS MIDLAND	U.S.	9	
408	414	KONINKLIJKE KPN	Netherlands	10.94		473	709	YUM! BRANDS	U.S.	9	
409	352	LOEWS	U.S.	10.93		474	322	SERONO	Switzerland	9	
410	476	AIR PRODUCTS & CHEMICALS (7)	U.S.	10.92		475	430	MEDIASET	Italy	9	
411	NR	PRINCIPAL FINANCIAL GROUP	U.S.	10.90		476	698	LATTICE GROUP	Britain	9	
412	678	LIMITED BRANDS	U.S.	10.89		477	445	PUBLIC SERVICE ENTERPRISE GROUP	U.S.	9	
413	357	SCOTTISH POWER	Britain	10.88		478	577	CONSOLIDATED EDISON	U.S.	9	
414	390	BURLINGTON NORTHERN SANTA FE (7)	U.S.	10.86		479	707	INTUIT	U.S.	9	
415	472	GOLOEN WEST FINANCIAL	U.S.	10.83		480	642	STARBUCKS	U.S.	9	

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RANK			MARKET VALUE			RANK			MARKET VALUE		
2002	2001		Billions of U.S. dollars			2002	2001		Billions of U.S. dollars		
481	752	PEPSI BOTTLING GROUP (7)	U.S.	9.25		546	407	ALLERGAN (7)	U.S.	8.1	
482	535	CRH	Ireland	9.24		547	574	ALLEANZA ASSICURAZIONI	Italy	8.1	
483	622	MATTEL	U.S.	9.19		548	565	MEDIMMUNE	U.S.	8.1	
484	598	PRAXAIR	U.S.	9.15		549	508	KIRIN BREWERY	Japan	8.1	
485	503	PORTUGAL TELECOM	Portugal	9.14		550	599	LEXMARK INTERNATIONAL	U.S.	8.1	
486	474	YAMATO TRANSPORT	Japan	9.11		551	588	ACCORD	France	8.1	
487	579	GREAT-WEST LIFE	Canada	9.11		552	651	M&T BANK (7)	U.S.	8.1	
488	701	NEWELL RUBBERMAID	U.S.	9.11		553	671	COMPUTER SCIENCES (7)	U.S.	8.0	
489	578	HERSHEY FOODS (7)	U.S.	9.10		554	NR	AMERISOURCEBERGEN (7)	U.S.	8.0	
490	524	ADN	U.S.	9.09		555	683	VDLVO	Sweden	8.0	
491	186	VERITAS SOFTWARE	U.S.	9.09		556	889	SVENSKA CELLULOSA AKTIEBOLAGET	Sweden	8.0	
492	396	SEAT PAGINE GIALLE	Italy	9.07		557	236	HALLIBURTON	U.S.	8.0	
493	533	ACE (7)	U.S.	9.06		558	692	AMSOFT CORPORATION (7)	U.S.	8.0	
494	690	LUXOTTICA GROUP	Italy	9.06		559	649	EISAI	Japan	8.0	
495	526	KEYENCE	Japan	9.03		560	856	FORTUNE BRANDS	U.S.	7.9	
496	625	BODYS	Britain	9.01		561	750	CHARTER ONE FINANCIAL (7)	U.S.	7.9	
497	471	WEST JAPAN RAILWAY	Japan	8.99		562	691	FISERV	U.S.	7.9	
498	507	UNICAL	U.S.	8.99		563	461	XCEL ENERGY (7)	U.S.	7.9	
499	454	AGF	France	8.97		564	NR	DENTSU	Japan	7.9	
500	537	RAS	Italy	8.94		565	521	BANCO COMMERCIAL PORTUGUES (BCP)	Portugal	7.9	
501	443	ASML HOLDING	Netherlands	8.93		566	596	SUNGAR DATA SYSTEMS	U.S.	7.9	
502	527	UNIVISION COMMUNICATIONS (7)	U.S.	8.88		567	993	GLOBAL SANTAFE	U.S.	7.9	
503	602	CINTAS	U.S.	8.87		568	664	EQUITY RESIDENTIAL	U.S.	7.9	
504	434	ST. PAUL	U.S.	8.86		569	708	ALMANY	Belgium	7.9	
505	584	DELPHI (7)	U.S.	8.83		570	459	THOMSON MULTIMEDIA	France	7.8	
506	564	SOUTHRUST	U.S.	8.83		571	541	SYNDVUS FINANCIAL (7)	U.S.	7.8	
507	607	ELECTRONIC ARTS	U.S.	8.83		572	767	SUNCOR ENERGY	Canada	7.8	
508	546	BANCA MONTE DEI PASCHI DI SIENA	Italy	8.81		573	742	RENTOKIL INITIAL	Britain	7.8	
509	612	SCOTTISH & SOUTHERN ENERGY	Britain	8.76		574	349	AMVESCAP	Britain	7.8	
510	613	DCBC BANK	Singapore	8.73		575	496	ASAHI GLASS	Japan	7.8	
511	494	ESTEE LAUDER	U.S.	8.73		576	616	TOPPAN PRINTING	Japan	7.8	
512	512	CASINO, GUICHARD-PERRACHON	France	8.70		577	760	JOHNSON CONTROLS	U.S.	7.7	
513	551	SINGAPORE AIRLINES	Singapore	8.66		578	646	BDC GROUP	Britain	7.7	
514	69	QWEST COMMUNICATIONS INTL. (7)	U.S.	8.64		579	634	MGIC INVESTMENT (7)	U.S.	7.7	
515	242	SIEBEL SYSTEMS	U.S.	8.64		580	866	WOLWORTH LTD.	Australia	7.7	
516	576	HDYA	Japan	8.62		581	575	TOKYO GAS	Japan	7.7	
517	504	ADDBE SYSTEMS	U.S.	8.59		582	552	MTR	Hong Kong	7.6	
518	566	SWIRE PACIFIC	Hong Kong	8.54		583	883	UNIONBANCAL (7)	U.S.	7.6	
519	479	MARATHON OIL	U.S.	8.49		584	581	SUMITOMO CHEMICAL	Japan	7.6	
520	600	INGERSOLL-RAND	U.S.	8.47		585	638	APACHE	U.S.	7.6	
521	788	QUEST DIAGNOSTICS	U.S.	8.45		586	517	VNU	Netherlands	7.6	
522	NR	BRAMBLES INDUSTRIES	Australia/Brit.	8.45		587	696	NEW YORK TIMES	U.S.	7.6	
523	NR	AUTODZONE (7)	U.S.	8.43		588	300	TELIA	Sweden	7.6	
524	550	SMC	Japan	8.40		589	715	HONG KONG & CHINA GAS	Hong Kong	7.5	
525	509	LINCOLN NATIONAL	U.S.	8.38		590	623	TDK	Japan	7.5	
526	382	SANYO ELECTRIC	Japan	8.37		591	595	BIOMET (7)	U.S.	7.5	
527	969	PG&E	U.S.	8.37		592	720	ALLIED DMECO	Britain	7.5	
528	676	GAS NATURAL SDG	Spain	8.37		593	617	MITSUBI FUDOSAN	Japan	7.5	
529	614	THYSSEN KRUPP	Germany	8.34		594	744	DTE ENERGY	U.S.	7.5	
530	539	FEDERATED DEPARTMENT STORES	U.S.	8.33		595	441	MATSUSHITA COMMUNICATION INDUSTRIAL	Japan	7.5	
531	652	RDH & HAAS	U.S.	8.32		596	933	ALTANA	Germany	7.5	
532	NR	MITSUBI SUMITOMO INSURANCE	Japan	8.31		597	739	LAND SECURITIES	Britain	7.5	
533	618	ROLI BANCA 1473	Italy	8.31		598	NR	ARCELDOR	France	7.5	
534	636	FUJISAWA PHARMACEUTICAL	Japan	8.30		599	663	CHRISTIAN DIDR	France	7.4	
535	611	MBIA	U.S.	8.29		600	557	ORIX	Japan	7.4	
536	645	HONGKONG ELECTRIC HOLDINGS	Hong Kong	8.29		601	869	MOODY'S	U.S.	7.4	
537	669	REGIONS FINANCIAL (7)	U.S.	8.28		602	670	MEDIBANCA	Italy	7.4	
538	681	APPLE COMPUTER	U.S.	8.25		603	528	BIOGEN (7)	U.S.	7.4	
539	831	H&R BLOCK	U.S.	8.24		604	851	ST. JUDE MEDICAL	U.S.	7.4	
540	561	NORFOLK SOUTHERN	U.S.	8.22		605	592	HENDERSON LAND DEVELOPMENT	Hong Kong	7.4	
541	452	BURLINGTON RESOURCES	U.S.	8.17		606	699	CINCINNATI FINANCIAL	U.S.	7.3	
542	520	NIPPON MITSUBISHI DIL	Japan	8.16		607	703	PDW ERGEN	Britain	7.3	
543	633	DEVON ENERGY (7)	U.S.	8.16		608	NR	AFFILIATED COMPUTER SERVICES (7)	U.S.	7.3	
544	511	SUMITOMO TRUST & BANKING	Japan	8.16		609	246	WILLIAMS	U.S.	7.3	
545	673	HELLENIC TELECOMMUNICATIONS ORGANIZATION	Greece	8.14		610	570	DAMP SKIBSSELSKABET AF 1912	Denmark	7.3	

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Fax: + 34 91 420 64 56
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RANK			MARKET VALUE			RANK			MARKET VALUE	
2002	2001		Billions of U.S. dollars			2002	2001		Billions of U.S. d	
611	492	INVESTOR	Sweden	7.33	676	941	NORTH FORK BANCORPORATION	U.S.	6	
612	NR	ANTHEM	U.S.	7.33	677	761	HEINEKEN HOLDING	Netherlands	6	
613	255	CABLE & WIRELESS	Britain	7.32	678	787	AVERY DENNISON	U.S.	6	
614	632	GROUPE BRUXELLES LAMBERT	Belgium	7.31	679	893	AMERSHAM	Britain	6	
615	631	AMERAOA HESS	U.S.	7.31	680	626	OAMPSKIBSSELSKABET SVENBORG	Denmark	6	
616	667	AJINOMOTO	Japan	7.31	681	904	GENUINE PARTS	U.S.	6	
617	688	MOLEX (7)	U.S.	7.31	682	629	ELECTRICIDADE DE PORTUGAL (EOP)	Portugal	6	
618	590	CSX (7)	U.S.	7.31	683	583	NIPPON TELEVISION NETWORK	Japan	6	
619	956	ASSOCIATED BRITISH FOODS	Britain	7.24	684	758	AMEREN	U.S.	6	
620	798	TRANSCANADA PIPELINES	Canada	7.24	685	NR	MEADOWSVACO (7)	U.S.	6	
621	665	PETRO-CANADA	Canada	7.22	686	501	BANCA FIORENTINA	Italy	6	
622	553	OVER	U.S.	7.22	687	640	FUJI TELEVISION NETWORK	Japan	6	
623	705	SMITHS GROUP	Britain	7.15	688	659	LAGARDERE	France	6	
624	654	JEFFERSON-PILOT	U.S.	7.15	689	917	FAMILY DOLLAR STORES (7)	U.S.	6	
625	770	AMBAC FINANCIAL GROUP (7)	U.S.	7.14	690	409	PEOPLESOFT	U.S.	6	
626	811	SYNGENTA	Switzerland	7.11	691	639	NABORS INDUSTRIES	U.S.	6	
627	627	SUMITOMO CORP.	Japan	7.04	692	836	ELECTROLUX	Sweden	6	
628	637	STARWOOD HOTELS & RESORTS WORLDWIDE	U.S.	7.02	693	328	CAP GEMINI	France	6	
629	727	SKANDINAVISKA ENSKILDA BANKEN	Sweden	7.02	694	506	ROYAL & SUN ALLIANCE INSURANCE GROUP	Britain	6	
630	686	THALES	France	7.01	695	693	NOVELLUS SYSTEMS (7)	U.S.	6	
631	837	TRW (7)	U.S.	7.00	696	922	SCOTTISH & NEWCASTLE	Britain	6	
632	NR	AIFUL	Japan	6.99	697	867	ECOLAB (7)	U.S.	6	
633	908	LABORATORY CORP. OF AMERICA HOLDINGS (7)	U.S.	6.99	698	NR	WOLSELEY	Britain	6	
634	484	PROMISE	Japan	6.98	699	609	UNUMPROVIDENT	U.S.	6	
635	NR	AETNA	U.S.	6.98	700	594	GEORGIA-PACIFIC	U.S.	6	
636	909	GILEAD SCIENCES (7)	U.S.	6.94	701	846	E.W. SCRIPPS (7)	U.S.	6	
637	515	ALTERA (7)	U.S.	6.93	702	695	NIPPON UNIPAC HOLDING	Japan	6	
638	523	MONSANTO (7)	U.S.	6.92	703	549	BROADCOM (7)	U.S.	6	
639	775	DEGUSSA	Germany	6.92	704	NR	EDISON INTERNATIONAL	U.S.	6	
640	540	KINGFISHER	Britain	6.89	705	562	IMS HEALTH	U.S.	6	
641	485	CHIRON (7)	U.S.	6.87	706	732	OXFORD GROUP	Britain	6	
642	569	WANGONG	France	6.87	707	898	WMC	Australia	6	
643	805	UNION PLANTERS (7)	U.S.	6.86	708	803	CINERGY	U.S.	6	
644	604	TELENOR	Norway	6.86	709	964	COUNTRYWIDE CREDIT INDUSTRIES	U.S.	6	
645	730	SECURITAS	Sweden	6.86	710	NR	ITT INDUSTRIES	U.S.	6	
646	724	SYNTHES-STRATEC	Switzerland	6.86	711	555	SANMINA-SCI (7)	U.S.	6	
647	763	FORENINGSSPARBANKEN	Sweden	6.86	712	870	HERMES INTERNATIONAL	France	6	
648	620	ORIENTAL LAND	Japan	6.85	713	740	WEATHERFORD INTERNATIONAL	U.S.	6	
649	765	AMAZON.COM	U.S.	6.84	714	NR	MICROCHIP TECHNOLOGY (7)	U.S.	6	
650	464	ADVANTEST	Japan	6.83	715	894	MGM MIRAGE (7)	U.S.	5	
651	468	GENZYME GENERAL	U.S.	6.83	716	891	RADIO SHACK (7)	U.S.	5	
652	635	KYUSHU ELECTRIC POWER	Japan	6.82	717	823	SANOVIX	Sweden	5	
653	111	NORTEL NETWORKS	Canada	6.82	718	722	FRESENIUS MEDICAL CARE	Germany	5	
654	NR	ZIMMER HOLDINGS (7)	U.S.	6.79	719	653	CNA FINANCIAL (7)	U.S.	5	
655	721	SUZUKI MOTOR	Japan	6.79	720	726	OST SYSTEMS	U.S.	5	
656	432	FLEXTRONICS INTERNATIONAL (7)	U.S.	6.79	721	820	TALISMAN ENERGY	Canada	5	
657	455	3I GROUP	Britain	6.75	722	NR	AUTOROUTES DU SUD DE LA FRANCE (ASF)	France	5	
658	435	FIAT GROUP	Italy	6.72	723	477	SUMITOMO ELECTRIC INDUSTRIES	Japan	5	
659	548	KING PHARMACEUTICALS (7)	U.S.	6.71	724	832	YASUDA FIRE & MARINE INSURANCE	Japan	5	
660	514	SANKYO	Japan	6.70	725	668	SWATCH GROUP	Switzerland	5	
661	478	CELESTICA	Canada	6.66	726	881	LINCOLN	Germany	5	
662	344	SOLETRON	U.S.	6.65	727	944	MAGNA INTERNATIONAL	Canada	5	
663	269	ORACLE CORP. JAPAN	Japan	6.62	728	947	SIMON PROPERTY GROUP	U.S.	5	
664	854	MARSHALL & ISLES (7)	U.S.	6.61	729	915	WESFARMERS	Australia	5	
665	759	R.J. REYNOLDS TOBACCO HOLDINGS	U.S.	6.59	730	757	BJ SERVICES	U.S.	5	
666	585	FINMECCANICA	Italy	6.57	731	660	WOLTERS KLUWER	Netherlands	5	
667	NR	ALTAIS	Spain	6.57	732	815	WASHINGTON POST	U.S.	5	
668	587	TEXTRON	U.S.	6.56	733	NR	SOLVAY	Belgium	5	
669	641	TOHOKU ELECTRIC POWER	Japan	6.55	734	719	KERR-McGEE	U.S.	5	
670	529	IOEC PHARMACEUTICALS	U.S.	6.54	735	608	OSAKA GAS	Japan	5	
671	684	TF1 TELEVISION FRANCAISE 1	France	6.51	736	NR	APOLLO GROUP (7)	U.S.	5	
672	NR	NOMURA RESEARCH INSTITUTE	Japan	6.50	737	560	MATSUSHITA ELECTRIC WORKS	Japan	5	
673	920	UST	U.S.	6.47	738	813	WHARF HOLDINGS	Hong Kong	5	
674	814	ALLIANCE & LEICESTER	Britain	6.46	739	802	PARKER HANNIFIN	U.S.	5	
675	818	J.C. PENNEY	U.S.	6.45	740	937	IMPERIAL CHEMICAL INDUSTRIES	Britain	5	



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The BusinessWeek Global 1000

RANK			MARKET VALUE			RANK			MARKET VALUE	
2002	2001		Billions of U.S. dollars			2002	2001		Billions of U.S. dollars	
741	955	INTERNATIONAL GAME TECHNOLOGY	U.S.	5.72	806	NR	CIBA SPEZIALITAETENCHEMIE HOLDING	Switzerland		
742	753	DOLLAR GENERAL (7)	U.S.	5.72	807	NR	TYSIDN FOODS (7)	U.S.		
743	716	H. LUNDBECK	Denmark	5.71	808	NR	NUCDR	U.S.		
744	895	NATIONAL COMMERCE FINANCIAL (7)	U.S.	5.71	809	808	SEMPRA ENERGY	U.S.		
745	809	AMB GENERALI HOLDING	Germany	5.70	810	NR	GOLDEN STATE BANCORP (7)	U.S.		
746	689	TAISHO PHARMACEUTICAL	Japan	5.67	811	547	PPL (7)	U.S.		
747	819	SEIBU RAILWAY	Japan	5.66	812	359	RELIANT ENERGY	U.S.		
748	655	PACIFIC CENTURY CYBERWORKS	Hong Kong	5.66	813	987	LEGGETT & PLATT (7)	U.S.		
749	789	NOBLE	U.S.	5.66	814	NR	RADIAN GROUP (7)	U.S.		
750	785	BEAR STEARNS	U.S.	5.65	815	NR	PACCAR (7)	U.S.		
751	850	HILTON GROUP	Britain	5.65	816	NR	GREENPOINT FINANCIAL (7)	U.S.		
752	NR	SPX (7)	U.S.	5.64	817	NR	ENBRIDGE	Canada		
753	712	KINKI NIPPON RAILWAY	Japan	5.64	818	884	AGERE SYSTEMS (7)	U.S.		
754	843	EATON	U.S.	5.64	819	910	MABUCHI MOTOR	Japan		
755	NR	OFFICE DEPOT	U.S.	5.64	820	781	CHUGOKU ELECTRIC POWER	Japan		
756	525	TOC	Denmark	5.63	821	NR	WESTFIELD HOLDINGS	Australia		
757	682	SABRE HOLDINGS	U.S.	5.62	822	847	JONES APPAREL GROUP	U.S.		
758	975	POWER CORP. OF CANADA	Canada	5.61	823	NR	DUPONT CANADA	Canada		
759	991	SHISEIDO	Japan	5.61	824	821	MARUI	Japan		
760	NR	PLUM CREEK TIMBER (7)	U.S.	5.61	825	896	ZIONS BANCORPORATION	U.S.		
761	NR	SNAM RETE GAS	Italy	5.61	826	NR	PERNOD RICARD	France		
762	986	GROUPE UCB	Belgium	5.59	827	1000	WM. MORRISON SUPERMARKETS	Britain		
763	875	HANSON	Britain	5.58	828	743	JOHNSON ELECTRIC HOLDINGS	Hong Kong		
764	901	HEALTHSOUTH (7)	U.S.	5.57	829	737	NISOURCE	U.S.		
765	792	NATIONWIDE FINANCIAL SERVICES (7)	U.S.	5.56	830	NR	L-3 COMMUNICATIONS HOLDINGS (7)	U.S.		
766	714	DAIICHI PHARMACEUTICAL	Japan	5.55	831	NR	HUNTINGTON BANCSHARES	U.S.		
767	NR	AUTONATION (7)	U.S.	5.53	832	NR	ARAMARK (7)	U.S.		
768	NR	KNIGHT-RIDDER	U.S.	5.52	833	834	DAIKIN INDUSTRIES	Japan		
769	793	OJI PAPER	Japan	5.51	834	NR	W.W. GRAINGER	U.S.		
770	799	SOOEXHO ALLIANCE	France	5.50	835	621	CONSTELLATION ENERGY GROUP (7)	U.S.		
771	943	NATIONAL SEMICONDUCTOR (7)	U.S.	5.50	836	679	TERAORNE	U.S.		
772	NR	TOSTEM INAX HOLDING	Japan	5.50	837	NR	DAIKIN PHARMA	Japan		
773	NR	INVESTORS GROUP	Canada	5.47	838	NR	ATLAS COPCO	Sweden		
774	833	UNION FENOSA	Spain	5.47	839	978	HEALTH MANAGEMENT ASSOCS. (7)	U.S.		
775	936	AMERICAN STANDARD (7)	U.S.	5.46	840	918	BIOVAIL	Canada		
776	995	HARRAH'S ENTERTAINMENT	U.S.	5.46	841	916	TORCHMARK	U.S.		
777	858	TONENGENERAL SEKIYU	Japan	5.46	842	953	FIRST TENNESSEE NATL. (7)	U.S.		
778	890	TIFFANY	U.S.	5.46	843	827	ASAHI BREWERIES	Japan		
779	672	INVENSY	Britain	5.43	844	NR	BLOCKBUSTER (7)	U.S.		
780	796	ITOCHU	Japan	5.42	845	783	MERCK KGAA	Germany		
781	860	FOSTERS GROUP	Australia	5.40	846	NR	WHIRLPOOL (7)	U.S.		
782	606	MEDOLANUM	Italy	5.39	847	828	VULCAN MATERIALS (7)	U.S.		
783	NR	ST. GEORGE BANK	Australia	5.39	848	777	NVOIA (7)	U.S.		
784	NR	MMO2	Britain	5.39	849	932	NEXT	Britain		
785	863	UNITED UTILITIES	Britain	5.39	850	840	SYMANTEC (7)	U.S.		
786	961	BROWN-FORMAN (7)	U.S.	5.38	851	853	CAEENCE DESIGN SYSTEMS (7)	U.S.		
787	736	DAIKIN PHARMACEUTICAL	Japan	5.35	852	NR	SHERWIN-WILLIAMS	U.S.		
788	710	GRANADA	Britain	5.34	853	747	PREUSSAG	Germany		
789	822	KEYSPAN (7)	U.S.	5.32	854	844	ASSA ABLOY	Sweden		
790	755	JAPAN AIRLINES	Japan	5.32	855	662	STILWELL FINANCIAL (7)	U.S.		
791	951	CATHAY PACIFIC AIRWAYS	Hong Kong	5.32	856	444	SKANOIA FORSAKRING	Sweden		
792	700	ASAHI KASEI	Japan	5.31	857	713	SHIZUOKA BANK	Japan		
793	697	TOYOTA INDUSTRIES	Japan	5.30	858	212	JOS UNIPHASE (7)	U.S.		
794	718	SEKISUI HOUSE	Japan	5.30	859	NR	WILLIS GROUP HOLDINGS (7)	U.S.		
795	897	WOODSIDE PETROLEUM	Australia	5.30	860	NR	CIRCUIT CITY GROUP (7)	U.S.		
796	375	SOFTBANK	Japan	5.29	861	610	SHIONOGI & CO.	Japan		
797	NR	YAHOO! JAPAN	Japan	5.28	862	859	DELHAIZE GROUPE	Belgium		
798	745	KINDER MORGAN	U.S.	5.28	863	NR	ROCKWELL COLLINS (7)	U.S.		
799	942	VINCI	France	5.28	864	865	EOG RESOURCES (7)	U.S.		
800	994	SMITH & NEPHEW	Britain	5.26	865	912	DOV JONES	U.S.		
801	948	HILTON HOTELS	U.S.	5.26	866	NR	ARCHSTONE-SMITH TRUST (7)	U.S.		
802	930	MICHELIN	France	5.26	867	NR	FORTUM	Finland		
803	855	NITTO DENKO	Japan	5.25	868	NR	DEUTSCHE BOERSE	Germany		
804	874	NIPPON EXPRESS	Japan	5.25	869	601	NATIONAL BANK OF GREECE	Greece		
805	675	DEUTSCHE LUFTHANSA	Germany	5.24	870	771	TDKYU	Japan		



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The BusinessWeek Global 1000

RANK			MARKET VALUE		RANK		MARKET VALUE	
2002	2001		Billions of U.S. dollars		2002	2001	Billions of U.S. dollars	
871	NR	VORNAO REALTY TRUST (7)	U.S.	4.71	936	NR	SINGAPORE PRESS HOLOINGS	Singapore
872	NR	SAFEWAY PLC	Britain	4.70	937	NR	OAIWA BANK HOLDINGS	Japan
873	NR	NIOEC	Japan	4.68	938	NR	PROLOGIS (7)	U.S.
874	935	VF (7)	U.S.	4.67	939	892	LI & FUNG	Hong Kong
875	861	MITSUBISHI MOTORS	Japan	4.66	940	931	QLOGIC (7)	U.S.
876	NR	THE BRITISH LANO COMPANY	Britain	4.63	941	NR	OXFORD HEALTH PLANS (7)	U.S.
877	886	OASSAULT SYSTEMES	France	4.60	942	981	PUBLICIS	France
878	NR	TELECOM CORP. OF NEW ZEALAND	New Zealand	4.59	943	NR	MURPHY OIL (7)	U.S.
879	542	BROCAOE COMMUNICATIONS SYSTEMS (7)	U.S.	4.59	944	NR	RYANAIR HOLOINGS	Ireland
880	NR	OSM	Netherlands	4.57	945	NR	IRISH LIFE & PERMANENT	Ireland
881	864	KUBOTA	Japan	4.57	946	772	LSI LOGIC (7)	U.S.
882	791	BALOISE HOLOING	Switzerland	4.55	947	615	HAYS	Britain
883	985	TRANSATLANTIC HOLOINGS (7)	U.S.	4.55	948	NR	EFG EUROBANK ERGASIAS	Greece
884	NR	HUSKY ENERGY	Canada	4.54	949	NR	VALERO ENERGY (7)	U.S.
885	NR	OOLLAR TREE STORES (7)	U.S.	4.54	950	NR	LONZA GROUP	Switzerland
886	804	JABIL CIRCUIT	U.S.	4.54	951	921	CANADA LIFE FINANCIAL	Canada
887	979	BANK OF YOKOHAMA	Japan	4.53	952	582	MILLENNIUM PHARMACEUTICALS	U.S.
888	NR	P&O PRINCESS CRUISES	Britain	4.53	953	NR	CENTROS COMERCIALES CARREFOUR	Spain
889	857	ALTRAN TECHNOLOGIES	France	4.52	954	738	SONERA	Finland
890	794	TOTAL SYSTEM SERVICES (7)	U.S.	4.51	955	NR	INCO	Canada
891	774	ALLEGHENY ENERGY	U.S.	4.51	956	NR	BISYS GROUP (7)	U.S.
892	NR	PLACER DOME	Canada	4.51	957	NR	EXPRESS SCRIPTS (7)	U.S.
893	885	NIPPON YUSEN	Japan	4.50	958	348	AMDOCS (7)	U.S.
894	NR	SERVICEMASTER	U.S.	4.49	959	NR	NATIONAL BANK OF CANADA	Canada
895	NR	PUBLIC STORAGE (7)	U.S.	4.49	960	776	BMC SOFTWARE (7)	U.S.
896	959	T. ROWE PRICE (7)	U.S.	4.48	961	NR	WESTWOOD ONE (7)	U.S.
897	NR	COW COMPUTER CENTERS (7)	U.S.	4.48	962	NR	SCANIA	Sweden
898	754	TELEPHONE & DATA SYSTEMS (7)	U.S.	4.45	963	888	METRO-GOLOWYN-MAYER (7)	U.S.
899	NR	COMPASS BANCSHARES (7)	U.S.	4.44	964	NR	SAFECO (7)	U.S.
900	NR	NORTHERN ROCK	Britain	4.44	965	748	TORAY INDUSTRIES	Japan
901	849	DIAMOND OFFSHORE DRILLING (7)	U.S.	4.44	966	976	HEIOELBERGER DRUCKMASCHINEN	Germany
902	NR	COLES MYER	Australia	4.44	967	949	OMRON	Japan
903	267	CORNING (7)	U.S.	4.43	968	NR	ESSILOR INTERNATIONAL	France
904	741	CONVERGYS (7)	U.S.	4.42	969	NR	WELLA	Germany
905	963	ENSCO INTERNATIONAL (7)	U.S.	4.41	970	556	ROCKWELL AUTOMATION	U.S.
906	NR	MOHAWK INDUSTRIES (7)	U.S.	4.41	971	NR	KAWASAKI STEEL	Japan
907	NR	OARON RESTAURANTS	U.S.	4.41	972	984	AININ SEIKI	Japan
908	929	SAMPO	Finland	4.40	973	NR	ENGELHARD	U.S.
909	NR	CAREMARK RX (7)	U.S.	4.40	974	NR	COOPER INDUSTRIES (7)	U.S.
910	NR	SHIRE PHARMACEUTICALS GROUP	Britain	4.39	975	NR	ONB HOLOING	Norway
911	NR	WEIGHT WATCHERS INTERNATIONAL (7)	U.S.	4.39	976	NR	SOVEREIGN BANCORP (7)	U.S.
912	968	PECHINEY	France	4.38	977	NR	CORUS GROUP	Britain
913	NR	CENTURYTEL (7)	U.S.	4.38	978	NR	CANADIAN NATURAL RESOURCES	Canada
914	NR	FRIENOS PROVIOENT	Britain	4.38	979	NR	SUPERVALU (7)	U.S.
915	NR	COMPANIA ESPANOLA DE PETROLEOS (CEPSA)	Spain	4.37	980	NR	OLO REPUBLIC INTERNATIONAL (7)	U.S.
916	807	ALL NIPPON AIRWAYS	Japan	4.37	981	NR	SMURFIT-STONE CONTAINER	U.S.
917	NR	MITSUI CHEMICALS	Japan	4.37	982	312	GEMSTAR-TV GUIDE INTERNATIONAL	U.S.
918	345	BEA SYSTEMS (7)	U.S.	4.37	983	NR	BRASCAN	Canada
919	992	ONO PHARMACEUTICAL	Japan	4.36	984	NR	EXPEIDIA (7)	U.S.
920	845	ROLLS-ROYCE	Britain	4.36	985	927	EQUIFAX	U.S.
921	685	BANCA NAZIONALE DEL LAVORO	Italy	4.36	986	NR	WENOS'S INTERNATIONAL	U.S.
922	810	PORSCHE	Germany	4.36	987	342	TELLABS (7)	U.S.
923	NR	POPULAR (7)	U.S.	4.35	988	395	NEXTEL COMMUNICATIONS (7)	U.S.
924	NR	AMERICAN WATER WORKS (7)	U.S.	4.35	989	NR	MAN GROUP	Britain
925	768	NETWORK APPLIANCE (7)	U.S.	4.34	990	NR	AMCOR	Australia
926	NR	CREOIT SAISON	Japan	4.34	991	NR	BANKNORTH GROUP (7)	U.S.
927	NR	ORKLA	Norway	4.34	992	597	SWISS LIFE	Switzerland
928	NR	LAMAR ADVERTISING (7)	U.S.	4.33	993	729	KONINKLIJKE NUMICO	Netherlands
929	899	ROBERT HALF INTERNATIONAL	U.S.	4.33	994	NR	OLYMPUS OPTICAL	Japan
930	NR	NIKON	Japan	4.33	995	NR	TCF FINANCIAL (7)	U.S.
931	965	DAILY MAIL & GENERAL TRUST	Britain	4.32	996	812	TRENO MICRO	Japan
932	NR	TELEKOM AUSTRIA	Austria	4.32	997	NR	VISHAY INTERTECHNOLOGY (7)	U.S.
933	NR	ROYAL CARIBBEAN CRUISES (7)	U.S.	4.32	998	NR	AMADEUS GLOBAL TRAVEL DISTRIBUTION	Spain
934	872	CANARY WHARF GROUP	Britain	4.31	999	NR	SEVERN TRENT	Britain
935	NR	SEGA	Japan	4.30	1000	536	ADVANCED MICRO DEVICES	U.S.

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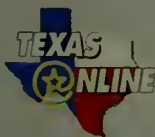
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The number preceding each company is its Global 1000 rank. The code following each company shows its nationality and rank within that nation. To find the statistics for a company, turn to the country listing and look for the company by its rank.

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506 SouthTrust (US-249)
332 Southwest Airlines (US-169)
976 Sovereign Bancorp (US-466)
269 Sprint FON Group (US-144)
425 Sprint PCS Group (US-213)
752 SPX (US-364)
783 St. George Bank (AS-14)
604 St. Jude Medical (US-295)
504 St. Paul (US-247)
322 Standard Chartered (BR-25)
448 Staples (US-221)
480 Starbuck's (US-235)
628 Starwood Hotels & Resorts (US-306)
277 State Street (US-147)
220 Statoil (NO-1)
855 Stibwell Financial (US-411)
174 STMicroelectronics (FR-13)
325 Stora Enso (FI-2)
419 Stryker (US-210)
150 Suez (FR-9)
54 Sumitomo Chemical (JA-74)
627 Sumitomo Corp. (JA-80)
723 Sumitomo Electric Industries (JA-94)
133 Sumitomo Mitsui Banking (JA-11)
544 Sumitomo Trust & Banking (JA-67)
221 Sun Hung Kai Properties (HK-4)
298 Sun Life Financial Svcs. of Canada (CA-8)
185 Sun Microsystems (US-99)
572 Sunco Energy (CA-21)
566 SunGard Data Systems (US-282)
210 SunTrust Banks (US-111)
979 Supervalu (US-467)
655 Suzuki Motor (JA-86)
556 Svenska Cellulosa Aktiebolaget (SWE-6)
403 Svenska Handelsbanken (SWE-4)
725 Swatch Group (SWI-16)
518 Swire Pacific (HK-6)
932 Swiss Life (SWI-20)
137 Swiss Re (SWI-6)
218 Swiscom (SWI-8)
850 Symantec (US-408)
626 Syngenta (SWI-14)
571 Synovus Financial (US-285)
646 Synthes-Stratec (SWI-15)
227 Sysco (US-118)

T
746 Taisho Pharmaceutical (JA-98)
95 Takeda Chemical Industries (JA-7)
439 Takefuji (JA-54)
211 Taisman Energy (CA-26)
103 Target (US-60)
995 TCF Financial (US-477)
755 TDC (DE-6)
590 TDK (JA-75)
878 Telecom Corp. New Zealand (NZ-1)
64 Telecom Italia (IT-2)
67 Telefonica (SP-1)
160 Telefonica Moviles (SP-4)
932 Telekom Austria (AT-1)
644 Telenor (NO-3)
898 Telephone & Data Systems (US-431)
588 Tela (SWE-7)
987 Tellabs (US-474)
119 Telstra (AS-1)
177 Tenet Healthcare (US-96)
836 Teradyne (US-400)
164 Tesco (BR-14)
71 Texas Instruments (US-43)
668 Textron (US-323)
671 TFI Television Francaise 1 (FR-38)
630 Thales (FR-36)
199 Thomson (CA-2)
570 Thomson Multimedia (FR-33)
657 3i Group (BR-55)
73 3M (US-44)
529 Thyssen Krupp (GE-23)
778 Tiffany (US-376)
109 TIM (IT-3)
200 TJX (US-194)
669 Tohoku Electric Power (JA-89)
154 Tokyo Electric Power (JA-14)
380 Tokyo Electron (JA-44)
581 Tokyo Gas (JA-73)
870 Tokuyama (JA-124)
777 Tomen General Sekiyu (JA-105)
386 T-Online International (GE-18)
756 Toppan Printing (JA-72)
965 Toray Industries (JA-137)
841 Torchemark (US-402)
256 Toronto-Dominion Bank (CA-4)
317 Toshiba (JA-35)
772 Tostem Inax Holding (JA-104)

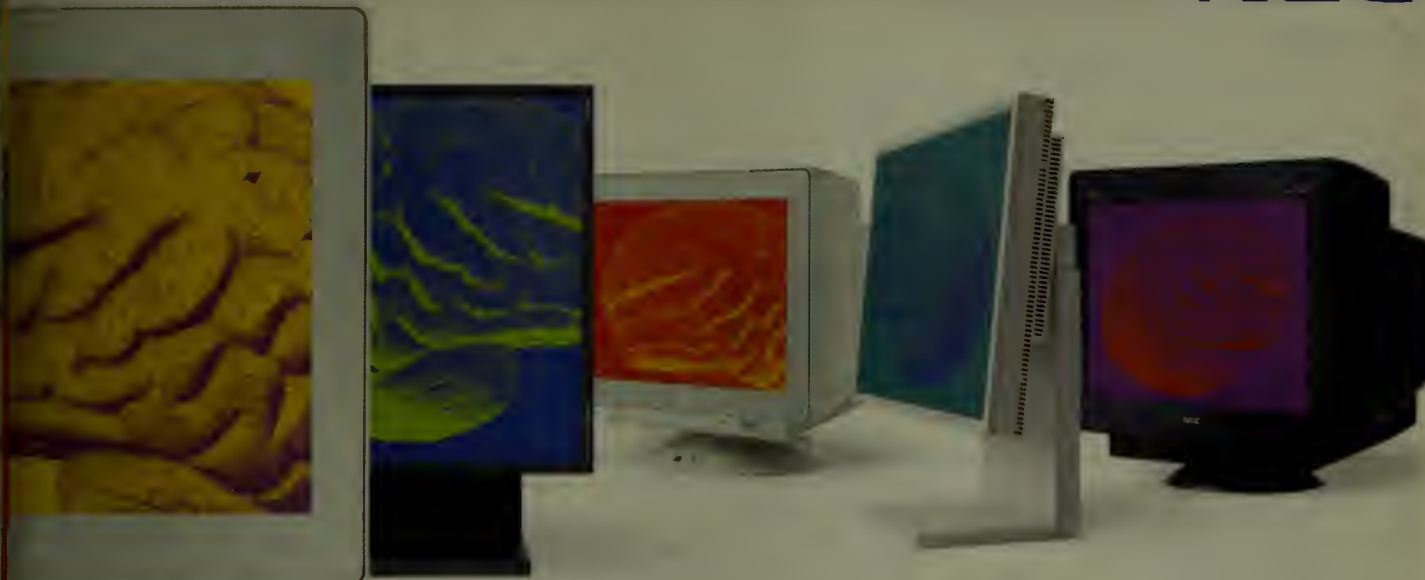
890 Total System Services (US-425)
26 TotalFinaElf (FR-1)
793 Toyota Industries (JA-110)
28 Toyota Motor (JA-2)
477 TPG (NE-13)
883 Transatlantic Holdings (US-422)
620 TransCanada PipeLines (CA-22)
369 Transocean (US-186)
237 Travelers Property Casualty (US-2)
996 Trend Micro (JA-142)
344 Tribune (US-174)
631 TRW (US-307)
315 TXU (US-164)
89 Tyco International (US-52)
807 Tyson Foods (US-381)

U
81 U.S. Bancorp (US-50)
47 UBS (SWI-4)
291 UFI Holdings (JA-28)
182 Uncredito Italiano (IT-6)
50 Unilever (NE/BR-NR)
NR Unilever NV (NE-4)
NR Unilever PLC (BR-13)
774 Unión Fenosa (SP-12)
275 Union Pacific (US-146)
443 Union Planters (US-314)
583 UnionBanCorp (US-288)
336 United Overseas Bank (S-2)
49 United Parcel Service (US-33)
127 United Technologies (US-71)
785 United Utilities (BR-67)
156 UnitedHealth Group (US-84)
502 Univision Communications (US-245)
498 Unocal (US-244)
689 UnumProvident (US-337)
436 UPM-Kymmene (FI-3)
384 USA Interactive (US-191)
673 UST (US-325)

V,W
949 Valero Energy (US-454)
491 Ventas Software (US-242)
20 Verizon Communications (US-15)
874 VF (US-420)
34 Viacom (US-24)
799 VINCI (FR-44)
997 Vishay Intertechnology (US-478)
407 Vivendi Environnement (FR-27)
121 Vivendi Universal (FR-7)
586 VNU (NE-15)
27 Vodafone Group (BR-4)
200 Volkswagen (GE-13)
555 Volvo (SWE-5)
871 Vornado Realty Trust (US-419)
877 Vulcan Materials (US-406)
66 Wachovia (US-40)
96 Walgreen (US-54)
4 Wal-Mart Stores (US-4)
76 Walt Disney (US-46)
642 Wanadoo (FR-37)
101 Washington Mutual (US-58)
732 Washington Post (US-355)
243 Waste Management (US-128)
711 Weatherford International (US-347)
911 Weight Watchers Intl. (US-440)
969 Wella (GE-35)
422 WellPoint Health (US-212)
33 Wells Fargo (US-23)
986 Wendy's International (US-473)
729 Westfarmers (AS-12)
497 West Japan Railway (JA-60)
821 Westfield Holdings (AS-16)
252 Westpac Banking (AS-7)
961 Westwood One (US-460)
292 Weyerhaeuser (US-154)
738 Wharf Holdings (HK-11)
846 Whirlpool (US-405)
609 Williams (US-298)
859 Willis Group Holdings (US-413)
707 WMC (AS-11)
698 Wolseley (BR-60)
731 Wolters Kluwer (NE-17)
795 Woodside Petroleum (AS-15)
580 Woolworths Ltd. (AS-9)
375 WPP Group (BR-32)
338 Wrigley (Wm.) Jr. (US-171)
42 Wyeth (US-29)

X,Y,Z
563 Xcel Energy (US-281)
381 Xilinx (US-89)
376 XL Capital (US-188)
469 Yahoo! (US-229)
797 Yahoo! Japan (JA-113)
450 Yamanouchi Pharmaceutical (JA-55)
486 Yamato Transport (JA-58)
724 Yasuda Fire & Marine Insurance (JA-7)
473 Yum! Brands (US-231)
624 Zimmer Holdings (US-317)
825 Zions Bancorp. (US-393)
212 Zurich Financial Services Group (SV)

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WE SHALL OVERCOME, TOO

A cadre of young, centrist African Americans is redefining black politics

In Alabama, congressional races are usually sleepy affairs. This has been especially true in the Seventh Congressional District, which includes parts of Birmingham and Montgomery, birthplace of the civil rights movement. For the past 10 years, the African American majority there overwhelmingly reelected civil rights standard-bearer Earl F. Hilliard, 60. But on June 25, the first black Alabamian to serve in Congress since Reconstruction was defeated in a \$1.5 million slugfest.

also joins a small but influential cadre of African Americans who are redefining what it means to be a black elected official. These young guns may be Democrats, but they are more centrist than their "take it to the street" elders, whose views were shaped by the civil rights struggle. They largely eschew Big Government and instead march to the cadence of economic growth, high-tech jobs, free trade, and even tax cuts. The day after his surprise upset, Davis pledged "to reach out in an aggressive

the old guard are Cory Booker, 33, who became a media darling when he challenged four-term Newark (N.J.) Mayor Sharpe James, 66. While Booker's bid fell short, he vows to run again.

Then there's Kwame M. Kilpatrick, the youngest elected mayor in Detroit history, and Representative Harold Ford Jr. (D-Tenn.), who won his father's seat in 1996 at age 26. And Dallas Mayor Ron Kirk, who at 48 is older than New Wave brethren, is giving Texas Attorney General John Cornyn a run for

A New Generation

Unlike older black leaders, younger black politicians have a pro-business agenda that doesn't cast the government as a savior



CORY BOOKER

The 33-year-old ex-Newark City Council member challenged four-term Mayor Sharpe James, 66



HAROLD FORD JR.

At the age of 26, the Tennessee Dem won his father's seat in Congress in 1996 but has higher ambitions



ARTUR DAVIS

The ex-prosecutor, 34, defeated a civil rights veteran to represent Alabama's Seventh Congressional District



KWAME KILPATRICK

The 32-year-old, scion of a political family, is the youngest elected mayor in the history of Detroit



RON KIRK

The twice-elected Dallas mayor, 48, is vying with the Texas AG for a U.S. Senate seat

The victor? Another African American. But the similarity ends there. Artur Davis, who defeated Hilliard in a Democratic primary runoff, is an ambitious, Harvard-educated former prosecutor who ran as a pro-business moderate. The 34-year-old Davis bested Hilliard by challenging him as an old-school pol and pounding at his support for the Palestinians.

With no Republican opponent, Davis is assured of a seat in Congress. He

manner to the business community."

This new breed is also more willing to experiment with alternatives to traditional social welfare programs. Some are amenable to vouchers and charter schools to fix public education. "The younger generation," says David J. Garrow, a Pulitzer Prize-winning civil rights historian, "is unwilling to simply embrace earlier agendas just because older generations espoused them."

Among others looking to push aside

money to represent the Lone Star State in the U.S. Senate.

The philosophical breach between younger and older black pols can be traced in part to their divergent experiences. As the older generation came of age, the federal government was a positive force in their lives. Washington not only removed the vestiges of Jim Crow laws but also provided money to build schools, create jobs, and subsidize health care and housing. But

cf.



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ger pols missed that struggle. "In 1964, I studied what my parents participated in," says Booker. The younger cohort seems more aware of the limits of what government can accomplish, particularly in the realm of education. For example, the poor performance of inner-city schools has produced startups such as Booker to support teachers, a position that doesn't sit well with the old guard. According to a study by the Joint Center for Political and Economic Studies, 49% of black officials between ages 18 and 40 support vouchers, compared with only 23% of those between ages 50 and 64. Now that the Supreme Court has declared vouchers constitutional, the younger black leaders may be more emboldened to champion the use of public funds for private education. Of course, to implement their agenda, these whippersnappers must first win the election. But the torch is rarely passed without a struggle. When polls showed that Davis was closing in on Ford, 27 House members, including

mother, Carolyn C. Kilpatrick, has represented Detroit in Congress for the past six years. And Ford's father, ex-Representative Harold Ford Sr., represented Memphis for 22 years. But the familial resemblances end there. Kilpatrick has pledged to expand Detroit's economy, not with new government programs but by attracting new technology companies. And Ford, a member of the conservative Blue Dog Coalition in the House, supports free-trade initiatives. Ford chafes at being confined to a traditional civil rights agenda. When asked to give the keynote address at the 2000 Democratic convention, he penned a stem-winder advocating tough education standards. Presidential nominee Al Gore's advisers, however, had their own speech, one laden with references to the civil rights struggle. Ford refused to deliver it, making his national debut as a New Dem who happened to be black, rather than vice versa. A centrist political philosophy has an obvious upside for black politicians:

The young guns' more centrist politics expands their appeal to white voters, giving them a better shot at winning statewide or even national office

Minority Leader Richard A. Gephardt (Mo.) and Minority Whip Nancy Pelosi (D-Calif.), sent checks to support incumbent. In Booker's case, New Jersey Governor James E. McGreevey promised to support a sports arena for Newark if voters reelected James. Many black leaders also worry that the young bloods have been too quick to abandon the civil rights cause. "There are still scars of racism embedded in our society," warns Representative John Lewis (D-Ga.), who organized the first lunch counter sit-in and who ordered campaign messages for Gephardt's reelection bid. "We are not there yet, and I hope the new breed understands that." Former Dallas Mayor Kirk says that, in running for office, he is paying homage to the generation that paved his way, but is under no obligation to push his philosophy. "Public service is the way I repay my parents," he says. "I want to be given the latitude to bring my experience to the table, and my experience is different from theirs." Scions of political families, such as Kilpatrick and Ford, have had an easy-time winning office. Kilpatrick's

They will have a better shot at winning statewide or even national office if they can appeal to moderate white voters. Ford openly discusses his ambitions to run for a Senate seat. And it's no accident that Kirk, who was twice elected mayor of racially diverse Dallas—the second time with 74% of the vote—boasts on the campaign trail of his strong ties to the business community. Kirk also likes to mention that, on his watch, the Dallas City Council cut property and auto taxes. "Their political philosophy has to speak to more than their African American constituents if they want to win outside of minority districts," says Al From, CEO of the centrist Democratic Leadership Council. With the graying of the civil rights movement, a generational hand-off is inevitable. On May 14, as Booker anxiously awaited election returns in the Newark mayoral primary, From called to lift the candidate's spirits. "I told Cory he shouldn't be disappointed if he lost," From says. "Regardless of the outcome, it spelled the end of Sharpe's career—and the beginning of his." *By Alexandra Starr in Washington*

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one Net
tech fact
of the week.

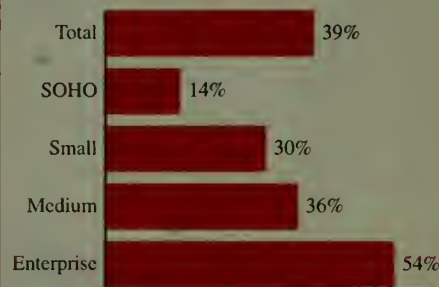
What percentage of companies use browser-based applications to conduct business with partners?

- a. 9%
- b. 39%
- c. 59%
- d. 89%

answer: "b"

In an online survey of 731 business people, nearly four in ten said they used browser-based applications (other than email) to do business with their outside partners or suppliers. Not surprisingly, the bigger the company, the more likely they were to use web-based applications to conduct business with partners.

Percentage of companies who use web-based applications to do business with partners



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TED BY OTIS PORT

W TO PUT
LL'S-EYES
CANCER CELLS

CANCER PATIENTS, NOTHING earlier than metastasis—spread of malignant cells, signaling that the cancer can't be cured. But a strategy conceived by Philip S. Low, a Purdue University biologist, and Endocyte of Lafayette, Ind., has tested more than 200 mice with advanced metastatic lung cancer. The approach will be tested in people this fall. The trick is to tag cancer cells, wherever they are, so they can be spotted by the immune system or targeted drugs. For tags, Low and Endocyte team use a dye called fluorescein. Injected into a mouse, it prompts the animal to produce antibodies that can recognize the dye. Next, the immune system attaches fluorescein molecules to folate, a form of vitamin B that certain types of cancer cells—lung, colon, and kidney tumors, for example—capture and rely on their surfaces. When the same mouse is injected with the combined molecules, the tumor cells that capture the folate also end up capturing the immunogenic dye. That means the immune system can spot and destroy the tumors. Aliya Sternstein

SERIOUS UPGRADE
FOR THE
CRUISE MISSILE

CRUISE MISSILES FLY AT A relatively leisurely speed of about 550 mph. That's slow enough to be shot down by advanced air-defense systems. But a new breed of hypersonic cruise missile is about to zip past any foreseeable defense and smack transient targets almost instantly from hundreds of miles away. The engine for these fu-

EARTH OFF THE BALANCE

RECENT SCIENTIFIC STUDIES CONTINUE TO WARN THAT humanity's demands on natural resources are reaching, or have already hit, unsustainable levels. Perhaps the most dire analysis comes from an international group of scholars led by Mathis Wackernagel, a researcher at the Redefining Progress think tank in Oakland, Calif. Published on the Web site of the *Proceedings of the National Academy of Sciences*, the study measured mankind's "ecological footprint" over the past 40 years. The researchers calculated the globe's total resources for growing crops, raising feedstock, harvesting timber, burning fuels, and fishing. Their preliminary findings: Demand on the biosphere now outstrips what it can supply. Humanity was using 70% of the earth's regenerative capacity in 1961, reached parity in the mid-1970s, and demand has exceeded the biosphere's ability to replenish its resources by at least 25% since 1999. Meanwhile, environmental scientist Richard Gill at Washington State University is focusing on the ability of soil to absorb excess carbon dioxide. As reported in the June 6 issue of *Nature*, his work at an Agriculture Dept. field lab near Temple, Tex., isn't encouraging. Greenhouse gas levels haven't been rising as fast as CO₂ emissions because the soil has been soaking up the CO₂. However, the soil seems to be approaching saturation, which would mean that global warming may soon begin to accelerate. ■



turistic speed demons was developed by Johns Hopkins University's Applied Physics Laboratory (APL) in Laurel, Md. It was ground-tested by NASA on May 30 and performed flawlessly under simulated conditions at 90,000 feet and a speed of Mach 6.5. That's 6.5 times the speed of sound, or roughly 4,250 mph. Thus, even a target at the missile's maximum range of 700 miles can be reached in only 10 minutes. The new powerplant is a so-called ramjet. Unlike ordinary jet engines, ramjets

don't have a turbofan to suck in air. Instead, they rely on hypersonic speed to force air into special intake scoops. A rocket would launch the missile, and the ramjet would kick in at Mach 3.5. The new engine is next slated to begin a series of flight tests that will run until 2005. APL's two industrial partners—Boeing and GenCorp's Aerojet unit, which built the engine—are handling this phase of the HyFly program. ■

FIGHTING FIRE
WITH MAN-MADE
RAINSTORMS

WITH FOREST FIRES RAGING in Colorado, California, and Arizona, scenes of helicopters dumping big, 150-gallon buckets of water on blazing trees have become a staple of TV news. A team of aerospace engineers led by Ralph E. Pope Jr. thinks there's a better way to fight fires: artificial thunder clouds in the form of gigantic airships, or dirigibles. Pope's startup, Wetzone Engineering in Huntington Beach, Calif., was formed by a group of airship engineers who left Lockheed Martin Corp. and Boeing Co. They envision a 1,000-foot-long airship that carries nearly a quarter-million gallons of water and discharges it through big showerhead nozzles at up to 60,000 gallons an hour. The ship could provide a steady downpour for four hours—longer, if copters replenished its reservoir. Pope figures the first model "will cost a godawful amount, maybe \$80 million." But he hopes to attract investors because both World SkyCat in Oxford, England, and CargoLifter in Brand, Germany, are gearing up to build a new generation of mammoth airships designed to haul loads weighing up to 1,000 tons. SkyCat expects to launch its first dirigible later this year, while CargoLifter's launch is not likely before 2005. SkyCat and Wetzone are collaborating on a family of airships, at varying price points, for different terrains and various sizes of forest fires. ■

WET ZEPPELIN:
An artist's rendering of a dirigible fire-fighting ship



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COMMENTARY

By Paul Magnusson

SMALLPOX: WHO SHOULD BE IMMUNIZED?

Short of a nuclear missile attack, nothing would be quite as devastating to America as a half-dozen terrorists loose in urban subways with containers of airborne smallpox virus. In a worst-case scenario, hundreds of unwitting commuters could soon experience flu-like fevers and aches lasting for about two weeks. Before the first figuring skin pox appear, the victims would spread the deadly virus to others. Within one month, an epidemic could rage out of control, killing one-third of the people infected. Of the remainder, one-third would be blinded, and many more terribly scarred.

The U.S. government can't guarantee that such an attack won't occur, but it will soon have the means to thwart the terrorists. By the fall, U.S. stockpiles of smallpox vaccine will reach nearly 100 million doses, enough for the entire population. Then, the Bush Administration will have to choose among a range of options. It can permit the vaccination of up to 20,000 medical personnel, as recommended on June 20 by an advisory medical panel. Or it could heed Richard Levinson at the American Public Health Assn. and "immunize everyone as quickly as possible." The best approach, however, is a middle path that received little attention: allow carefully screened, healthy adults to volunteer for vaccination. "The more volunteers you vaccinate, the slower the spread of any disease through the general population, and the more time you have to vaccinate the rest," says William J. Bicknell at the Boston University School of Public Health.

For now, the government plans to stick with a tried-and-true approach called "ring containment." The idea: treat the sick and vaccinate anyone



WHY THE VIRUS STRIKES TERROR

- ▶ Smallpox kills a third of its victims and blinds others
- ▶ The virus has been stockpiled in the U.S. and Russia
- ▶ North Korea and Iraq may also have their own stockpiles
- ▶ Inoculation programs ended in the U.S. in 1972
- ▶ Few people retain immunity from past vaccinations

they may have come in contact with. This approach was last used in the U.S. in 1947 when an infected businessman arrived from Mexico by bus in New York City. Authorities vaccinated more than 6 million people in a month. Only 12 contracted the disease, and just two died.

The trouble is, ring containment is based on a chance outbreak, not a terrorist attack. "It is not going to work against a thinking agency like al Qaeda in a highly mobile, concentrated, and unvaccinated society," says Randall J. Larsen, director of the ANSER Institute for Homeland Security, a Washington think tank. Forced to respond to a series of attacks in different cities, health officials would be quickly overwhelmed.

So why not just vaccinate everyone and stop worrying? Two big reasons: Scientists estimate that mass vaccinations could lead to unacceptably high rates of complications—up to four deaths per million from encephalitis and other maladies, as well as lesser skin rashes. Secondly, the vaccine is itself a live virus, albeit

far less harmful than smallpox, and it's contagious. In past immunization programs, 20% of those suffering vaccine-related symptoms had not been inoculated themselves. "That's what makes it a societal deci-

CURBING A SCOURGE: Smallpox vaccinations in New York City in 1947

sion and not just a personal choice," says D.A. Henderson, a U.S. scientist who led the worldwide fight to stamp out

smallpox in the 1970s.

The middle path addresses both objections. Screening out people whose immune systems are already damaged by AIDS or cancer treatments, while barring young children, could cut vaccine-related deaths to

an estimated one in a million, says Bicknell. In addition, vaccinated volunteers would naturally produce a substance in their blood called vaccinia immune globulin, which could be harvested and administered as a therapy to people suffering mild complications.

The risk of a terrorist attack can't be quantified. But homeland security experts note ominously that both Iraq and North Korea vaccinate at least some of their military, suggesting that they may have stockpiles of smallpox. And Russians once produced tons of highly weaponized forms of the virus, some of which may now be in terrorists' hands.

There are no easy answers, allows Henderson. He advocates a cautious approach, noting that "this is a risk-averse society." That's true. But it's also why the government ought to allow some voluntary vaccinations, and let people decide for themselves if the risk is worth the taking.

Magnusson covers homeland security from Washington, D.C.



STRATEGIES

CAN SOFTWARE STOP SUN'S SLIDE?

The server maker is betting big on it—once again

It's been a rough year for computer server manufacturer Sun Microsystems Inc. Its free-spending Internet customers have gone the way of the dodo. The soft economy has hurt demand across the board. Most worrisome, it's losing market share to hard-hitting competitors, such as Dell Computer Corp. With its troubles mounting, Sun's stock has plummeted to less than \$5, a 92% drop from its \$64 peak in 2000.

So how do Sun execs plan to get out of this pickle? In a word, software. While a stronger economy will help sales recover somewhat, the company's

top brass think the hardware giant needs to act more like a software company to address its long-term challenges. In a move underscoring the importance of the strategy, Jonathan Schwartz, Sun's chief competitive officer for the past three years, took over the newly created position of executive vice-president for software development on July 1. "Software is right at the center of the future of this company," says Schwartz.

The software strategy, dubbed Sun ONE, for Open Net Environment, is designed to spark sales across the compa-

WITH THE PROGRAM

"Software is right at the center of the future of this company," says software V-P Schwartz.

ny's product lines, from server data-storage gear. The idea is to use software as a Trojan horse to get into big corporate accounts. They will then buy more of everything from Sun. The most aggressive move is Sun's decision to give away its entry-level application-server software, a \$3,000-and-up product that handles simple e-business tasks like e-commerce transactions and runs the software for more complex e-business functions. Out in the door, Sun figures it will more easily sell additional software things like controlling employee access to networks. That should allow the company to grab a slice of the \$28 billion infrastructure-software market—and sell more hardware. To back up the effort, the company in May set up a 1,000-person sales and service group dedicated to selling software.

No question, Sun needs to do something about its sagging finances. The Palo Alto (Calif.) company's revenues for the fiscal year that ended June 30 are expected to be about \$12.4 billion, down from a year ago. The company's

gross margins have slipped to an estimated 40% this year, compared to 54% last year. Although it is expected to break even in the June 30 quarter—the first time that has happened in a year—many analysts question whether the economy alone can spark renewed growth. "Sun has serious, serious technology and strategic problems," says Bill Whyman, an analyst at the PricewaterhouseCoopers Group, an independent research firm in Washington, D.C.

The company is being squeezed on both sides. Dell is concentrating on \$10,000 servers and has boosted its share of the overall market to 7.4% in the first quarter, from 5% in 2000, according to International Data Corporation. Meantime, IBM is a strategic threat at the high end because it can offer corporate customers complete, easy-to-use e-business systems with hardware, software, and everything else in between. The result: Sun's share of the server market has dropped to 14.9% in the first quarter, from 17.0% in 2000, IDC says.

How will Sun's new strategy help? At the moment, software accounts



WHAT CAN A
CANOE
TEACH US ABOUT
PARTNERSHIP?



*It's best if you go with someone who's done it before
You cover more distance when you work in tandem
Whether you get soaked depends on proper balance*

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Information Technology

less than 5% of Sun's overall revenues, according to Whyman, so even doubling software sales would do little for top-line growth. Still, the initiative will give Sun a broader product lineup to compete with IBM, and it could fatten Sun's profits. Business software carries gross margins north of 80%, compared with about 30% for most hardware. Doubling software sales could add about \$500 million in gross profit, compared with \$200 million for a comparable revenue increase from hardware products. Sun won't specify its targets for software sales or hardware sales driven by software.

For all its grand plans, Sun faces long odds given its track record. As far back as 1993, Sun was promising to beef up its software business. Since then, it has

tegrate the two application servers, stumbled, and didn't get a new product out the door for nearly two years. Meanwhile, IBM and BEA introduced upgrades at least once a year. As the app-server market boomed to \$2 billion annually, IBM and BEA dominated, together selling more than half the app servers in the world. Sun is expected to slip to a distant third this year, with a 12% share of the market, according to AMR Research Inc. That puts it neck and neck with rival Microsoft and database giant Oracle Corp.

Sun ONE is an attempt to take at least part of that market back. In May, Sun started bundling, for free, its application server with its own Solaris server-operating system. That's only a first step. Later this year, the company will offer the free version

Sun can offer complete e-business terms, then videotaped them all giving a three-minute spiel. That should help push additional software to go with its application-server product. Sun's selling integration software that ties computer systems together and works neatly with the application-serverware, directory software that connects the identities of people using a computer network, and so-called portal software that makes it easier to share information over a corporate network. Finally, by early next year, Sun will offer two high-end versions of its app server that address specific needs of big corporate customers, such as ensuring reliability of their networks.

Sun's pitch, that it can offer complete computer systems with hardware and software, is resonating with some customers. They like the idea

that one company can respond quickly to any complaint. "I would like to have one that doesn't choke," says Tim Von Kistner, chief technical officer at Questerra, a Charlottesville, Va. tech company that has bought all of the software and hardware for its network from Sun.

Sun's plans for the future could really get some attention. The company is working on software, called N1, that is similar to the concept of grid computing. Grid would allow a company to collect huge amounts of computing power by using the Net to tap into unused computers around the country. Sun's N1 software would enable grid computing so its customers could get computing resources when they needed them. The next version of N1 is expected next year.

Put it all together, and Sun executives think they can finally compete for software deals. "Do we wish we had done this faster? Sure," says Nealy. "But we absolutely have the right offerings at the right place at the right time."

Still, Sun has a tough row to hoe in software. Ask competitors what they think of Sun, and they don't bristle; they scoff. "I think they've lost the window. They had an opportunity to create a software business," says Scott Lerner, director of marketing for IBM's app server, called WebSphere. After years of scuffling, this may be Sun's last shot to prove it can get software right.

By Jim Kerstetter in San Francisco

SUN, THE SOFTWARE COMPANY

Sun Microsystems is banking on software to help boost its outlook. But it will be a tough climb. Analysts estimate that software accounts for only 5% of Sun's \$12.4 billion in annual revenues. Here are its offerings and their pros and cons:

PRODUCT

HOW IT STACKS UP

JAVA Sun's programming language is used to create software—much like an alphabet is used to create a book.

Most business-software makers use Java. Sun doesn't make much money directly off Java, but execs say that more than 90% of Sun's hardware sales are related to software built with Java.

SOLARIS Sun's operating system is the market leader among computer servers that run Unix, with a 33.6% share.

The Unix market is sluggish, with sales down 24% in the last year. Sun server revenues in the first quarter were \$1.58 billion, off 23% year-over-year. Yet sales of servers running Microsoft's Windows 2000 fell 9%, and the free Linux OS fell 4%.

SUN ONE APPLICATION SERVER Sun is focusing on infrastructure software. Most important is the Sun ONE Application Server, which directs data for big e-business systems and Web sites.

Three years ago, Sun ruled the application-server roost. Now it's a distant third, with a 12% share of the \$2 billion market, behind BEA and IBM. Sun is trying to regain ground by giving away a low-end applications server with the Solaris operating system. That should help it gain entrée into more corporate accounts.

repeatedly tried—and failed—to become a bigger player in the market. "I respect Sun a great deal," says Alfred S. Chuang, CEO of Internet software giant BEA Systems Inc. "But they have never proven they know how to sell software."

The biggest missed opportunity came in 1998. When America Online Inc. acquired Net pioneer Netscape Communications Corp. that year, it handed control over Netscape's software to Sun, giving Sun the two top-selling application servers at the time. Although the market was tiny and fragmented among 40 companies, Sun's \$30 million-plus in app-server sales was 10% of the total market, twice that of its nearest competitor.

But Sun blew its lead. It tried to in-

tegrate the two application servers, stumbled, and didn't get a new product out the door for nearly two years. Meanwhile, IBM and BEA introduced upgrades at least once a year. As the app-server market boomed to \$2 billion annually, IBM and BEA dominated, together selling more than half the app servers in the world. Sun is expected to slip to a distant third this year, with a 12% share of the market, according to AMR Research Inc. That puts it neck and neck with rival Microsoft and database giant Oracle Corp.

And a good sales pitch. McNealy has forced Sun's more than 300 vice-presidents to master Sun's new message. He has had each one trained to explain that



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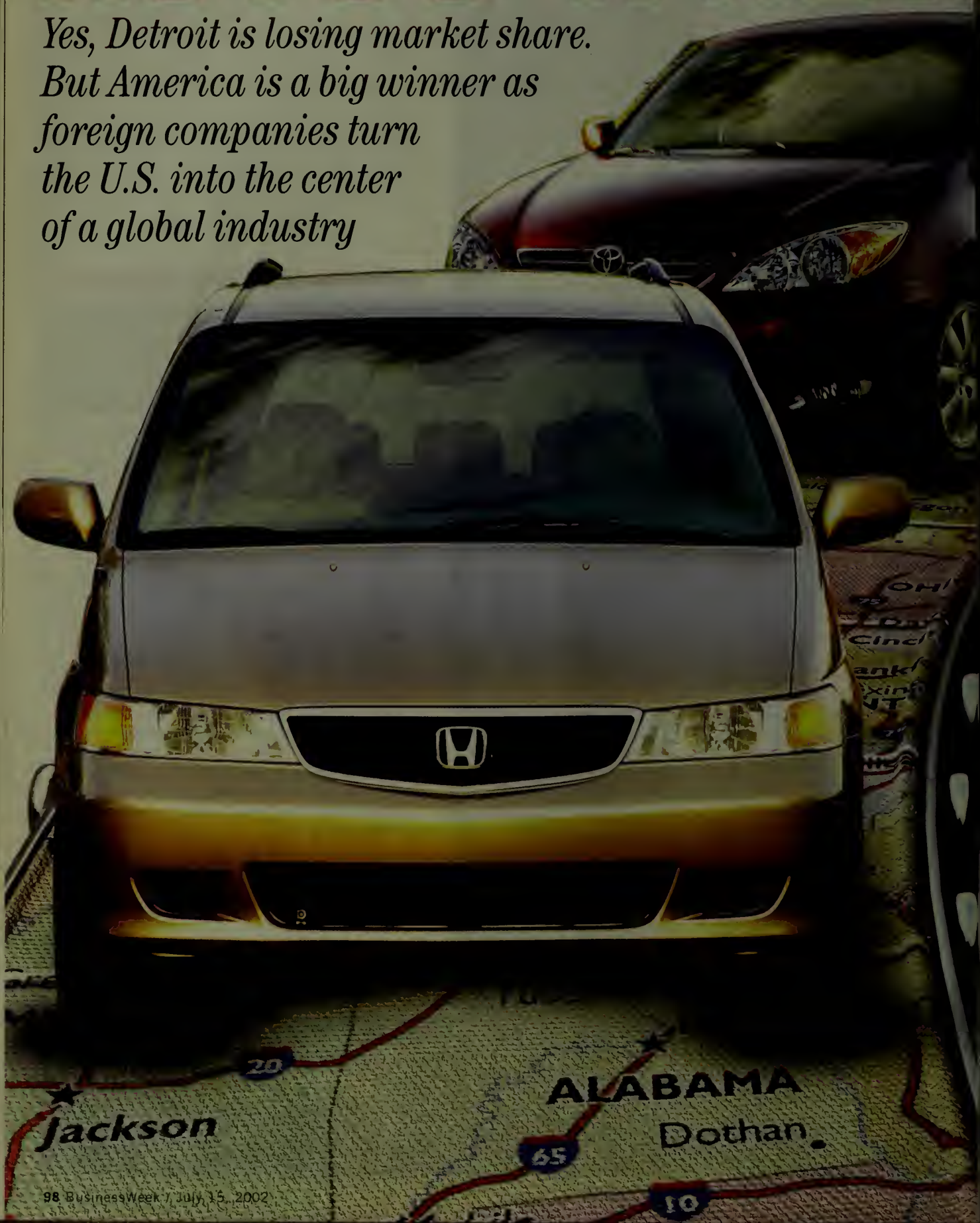
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AUTOS: A NEW

*Yes, Detroit is losing market share.
But America is a big winner as
foreign companies turn
the U.S. into the center
of a global industry*





HOMETOWN PARADE

The Honda Odyssey minivan (front), Toyota Camry sedan, Hyundai Santa Fe sport-utility vehicle, and Mercedes-Benz M-Class SUV. All are made in the U.S. except the Santa Fe, which will be by 2005

INDUSTRY

... industry represented America's industrial might in the 20th century, surely it was auto makers. The handful of companies clustered around Detroit produced the assembly line in 1913, tanks and aircraft engines during World War II, and thousands of high-paying factory jobs when peace came. The industry became the backbone of the U.S. economy and its companies America's bellwethers. As cars went, so went the nation.

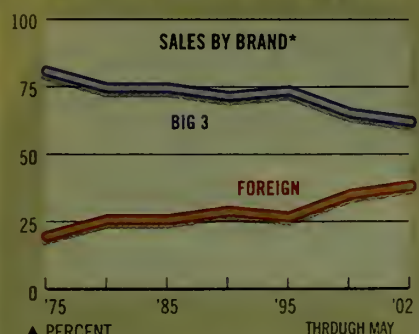
That's truer than ever, but it's no longer because of Motown's might. Today, it is foreign players that are reinvigorating America's car business—and turing the U.S. into the center of a global industry. An intense new wave of competition from Europe and Asia is forcing a fundamental transformation that is profoundly changing the way cars and trucks are designed and built. Of course, it's not the first time Detroit has been under assault by foreign auto makers, but this time, there's a difference. Instead of arriving by container ship or being assembled from imported parts in a handful of U.S. factories, this onslaught of cars, trucks, and sport-utility vehicles is born and bred in America. The revolution is taking place in a second generation of hyperefficient foreign-owned factories that are popping up across America's rural South, far from northern union halls, in places such as Lincoln, Ala.; Canton, Miss.; and Buffalo, W. Va.

The first Japanese transplant factory appeared 20 years ago when Honda Motor Co. began making cars in Marysville, Ohio. More followed, slowly at first. But now, they've reached a critical mass. The vehicles they make are increasingly being designed and engineered in this country. And with foreign-based manufacturers planning to boost their North American production capacity 40% by 2006, they will force a fundamental shift of investment dollars, jobs, and supplier assets from the North to the South and from American-owned companies to companies with overseas ownership. As the transplants crank out hot-selling vehicles such as Toyota Tundra pickups, Honda Odyssey minivans, and Mercedes M-Class SUVs, they're challenging notions of what constitutes a domestic industry. This shadow sector is more than just an encroachment: Today, more than half the passenger sedans sold in America are import brands—and more than half the vehicles sporting foreign nameplates are made in the U.S.

The new factories are woven deeply into the fabric of the U.S. economy. They spawn their own mini-galaxies of parts suppliers, subassemblers, and service businesses wherever they appear. And they're putting intense pressure on tradi-

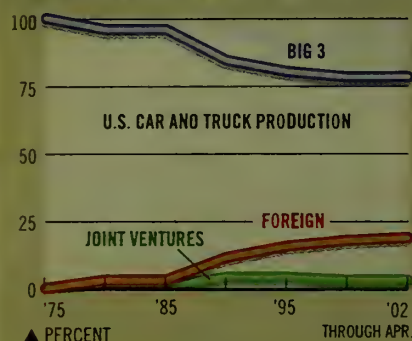
Cover Story

AS FOREIGN BRANDS GRAB MORE OF THE U.S. MARKET...



*BIG 3 IS DOMESTIC BRANDS ONLY; FOREIGN INCLUDES JAGUAR, VOLVO, SAAB, OTHER U.S.-OWNED FOREIGN BRANDS

...PRODUCTION IS SHIFTING TO TRANSPLANT FACTORIES...



INROAD An El Monte (Calif.) Toyota lot. Until recently, Detroit had c

tional American carmakers. Most important, they're forcing Detroit's Big Three to resume a painful restructuring that began two decades ago but was sidetracked by the '90s economic boom. "By putting it off, we may have amplified the consequences," says David E. Cole, executive director of the Center for Automotive Research (CAR) in Ann Arbor, Mich.

That may be bad news for Motown, but as globalization takes root at home, the U.S. is enjoying a massive infusion of talent and investment. Indeed, looked at more broadly, the U.S. auto market has never been healthier—or better served. Here's why:

■ **Better and cheaper cars.** Foreign auto makers have used their toehold in the U.S. and favorable currency rates to greatly heighten competition. That has given consumers higher quality, more choice, and lower prices from U.S. as well as foreign carmakers. The pressure has sparked a creative, more disciplined approach to product development that prizes quality and efficiency.

■ **Factory innovation.** When Honda built its first Accord in Marysville in 1982, the point was to dodge import quotas and political pressure. But the transplant factories opening now represent a huge advance in flexibility and efficiency. U.S. companies are beginning to follow, but with little hope of beating foreign-owned factories on costs, they must innovate or die a slow death.

■ **Job redistribution.** The new car factories now employ about 50,000 people, replacing thousands of jobs lost in textiles, steel, and other dying industries in the South. The billions of dollars invested by Honda, Toyota, Mercedes, BMW, Hyundai, and others is raising wage and skill levels and pressuring states to improve educational standards.

On the losing side of the ledger, of course, are the Big Three's old-style factories and their unionized workers. For years, the U.S. industry has been suffering a steady drip of lost market share to overseas rivals. But today, it is under attack on all sides: European luxury brands have roared past once mighty Cadillac and Lincoln, and Japanese carmakers are plowing into the lucrative truck market. Even those once-flim-

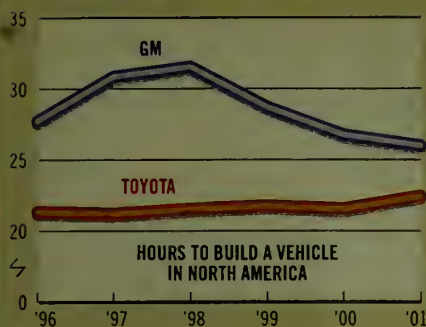
sy Korean cars have moved up the value chain and are winning first-time customers. The result has been a dizzy drop in U.S. market share for Detroit auto makers. Since 1995, they've lost a full 10 points to foreign-based rivals.

If this feels like déjà vu, that's because 20 years ago, Motown was pushed to the brink by an earlier wave of Japanese and European imports. The ultimate victory by Toyota, Honda, Nissan, BMW, and Mercedes was so complete that an entire generation of car buyers stopped considering American cars. GM, Ford, and Chrysler fought back, attacking the bloated costs and embracing many of the lean manufacturing principles that made the transplants so efficient. It was a painful reckoning, resulting in 150,000 jobs lost from 1979 to 1991. But by the mid-'90s, profits were up, and the clouds over Motown seemed to lift.

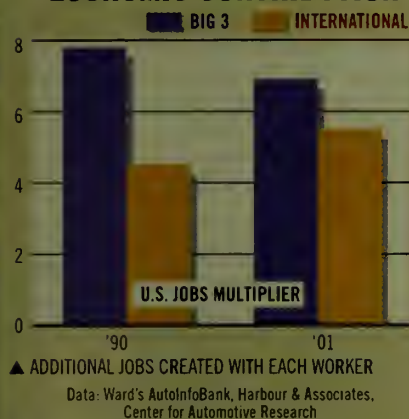
It has become clear, though, that what bailed out Detroit was not a profound new appreciation for global competition. Instead, it was a roaring U.S. economy and shifting consumer tastes. Americans had fallen in love with bulky minivans, SUVs, and pickups, all uniquely American concepts. With scant foreign competition, the Big Three feasted on those fat truck profits through most of the '90s, barely noticing that they had surrendered the car market to import brands. Detroit's swagger returned, and with it, bad old habits. Rather than conducting a housecleaning, Detroit shoved its problems to the back of the garage for a decade. "We have absolute collective amnesia in this business," says Ford Motor Co. Chairman William C. Ford Jr. "We can't handle success."

**THE
BIG THREE
Squeezed
On All
Sides**

...THAT HAVE A BIG EDGE IN PRODUCTIVITY...



...AND MAKE A RISING ECONOMIC CONTRIBUTION



makes it increasingly important to base other operations here, too. Nissan Motor Co. will build as many as 400,000 minivans, pickups, SUVs, and sedans at a new Mississippi plant starting next summer. It already has a large engineering unit in Farmington Hills, Mich., which is in the midst of a \$39 million expansion that will add 260 engineers and other technical workers. And, like all the carmakers, it has a design center in California.

Says Nissan CEO Carlos Ghosn: "North America is the most

profitable market in the world. The mix of vehicles is rich, and the richer the mix, the more your profits."

There's a danger that Detroit will keep slipping—right off the edge. The result: In a decade or so, the U.S. auto industry may no longer be dominated by domestic players. That's remarkable considering that 40 years ago, General Motors Corp. alone had a 50.7% market share and looked like a prime target for a government-ordered breakup. There's no chance of that happening now—America's biggest carmaker slipped to just a 28.1% share through May. What's more likely is that the U.S. could end up looking like Europe, with five or six players splitting roughly equal shares. "It's no longer the Big Three; it's the Big Five," says George Peterson, president of AutoPacific Group Inc., a Tustin (Calif.) consulting firm.

The transplant invasion is a sensitive topic in Detroit these days. G. Richard Wagoner Jr., GM's CEO, points out that the Japanese and Koreans can invest so heavily here because they dominate their home markets with virtually no outside competition. In a May speech in New York, Wagoner said, "Once these manufacturers establish a foothold in the U.S., they begin to mimic our broad product lines, eventually become accepted by the public as a 'domestic' brand, and suddenly, we lose our home-field advantage."

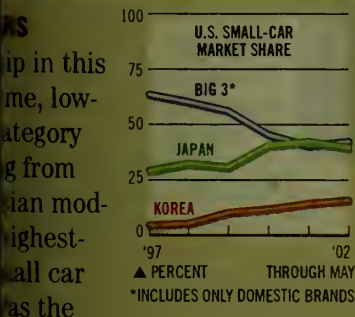
But globalization began blurring national auto identities years ago. Today, the concept of a purely American carmaker seems quaint. Even the term Big Three no longer seems appropriate, since Chrysler Corp. was acquired in 1998 by Daimler Benz, which has its own transplant factory building Mercedes SUVs in Vance, Ala. Japan, which had five major independently owned auto companies in 1998, now has only two: Toyota and Honda Motor Co. And just as Asian and European carmakers have been expanding in North America, U.S. companies have been looking for growth overseas. GM

Cover Story

up market

do our best as a company when our back is to the wall." He'd better hope so: Foreign auto makers are unveiling a host of impressive products aimed squarely at Detroit's profit centers. Having long since ceded the car market, Detroit is in danger of losing a big chunk of the lucrative SUV and minivan markets. Japanese, European, and South Korean companies have already grabbed more than seven points of share in the U.S. market just in the past five years, cutting Detroit's dominance from 83.6% to 76.3%.

There's a lot at stake. The U.S. auto market is by far the most vibrant in the world. Every lost point of U.S. market share represents a shift of \$4 billion in sales. Indeed, nearly half of the record \$8.8 billion in annual operating profit Toyota Motor Corp. reported in May came from the U.S. And that

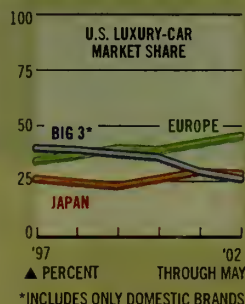


Cavalier; by 2001, it was the fastest-rising rival. But the fastest-rising rivals are ultra-low-cost Koreans, with models such as the \$12,500 Elantra (left).

LUXURY

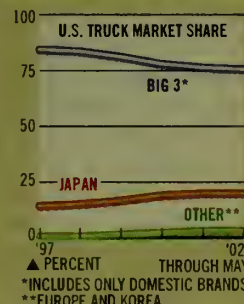
Nowhere has the slippage in U.S. prestige been more noticeable than in luxury cars. Cadillac was the top-selling brand in '97,

followed by Lincoln, but the Europeans were already setting the pace in design and engineering. Now, Lexus, BMW, Mercedes, and Acura rule the roost, with the BMW 3 Series (left) leading the way.



LIGHT TRUCKS

If there's one area in which America still rules, it's in trucks and SUVs. But even here, the Japanese are making headway. Over the past two years, they've launched such well-received vehicles as the Toyota Tundra pickup (below) and gained more than five points of market share.



As the ranks of nonunion workers grow, the UAW's power to set wages, if not its very survival, is in jeopardy

owns Saab and has stakes in Isuzu, Suzuki, Subaru, Fiat, and Daewoo. Ford owns Mazda, Volvo, Jaguar, Land Rover, and Aston Martin. DaimlerChrysler owns a controlling stake in Mitsubishi Motors and 10% of Hyundai Motor.

As the world's largest manufacturing companies jockey for power in the U.S., the tectonic shifts are only starting to rumble through the industry. Here are some of the ways the new auto industry is rewriting the rules of the road:

Cover Story

THE PULL OF THE SOUTH

The influx of auto factories in the South has been a bonanza for a region ravaged by factory closings and layoffs. Alabama alone has lost 40,000 textile and apparel jobs since NAFTA was enacted in 1994. When Mercedes opened its factory in Vance in 1997, 63,000 people requested applications for just 1,500 jobs. Alabama's Daniel Mendez, a 46-year-old Mexican immigrant, spent most of his life in a series of menial jobs and then a long stint in a hellish foundry making steel pipes. Now, his voice chokes with tears as he talks about his good fortune in landing a \$25-an-hour job at Mercedes. "In the foundry, I felt my mind was shrinking," Mendez says. "I never thought I'd find a place where I could retire."

It's a story being replayed across the South as farmland gives way to sprawling auto factories and related development. Today, there are 17 foreign-owned assembly, engine, and transmission factories in the U.S., not including American and Japanese joint ventures—an investment of more than \$18 billion. And that number is growing. BMW joined the boom in 1993 with its first assembly plant outside Germany. Its Spartanburg (S.C.) plant, which builds X5 SUVs and the brand-new Z4 roadster, keeps expanding its output. Toyota, Hyundai, and Nissan plan to open factories in Alabama and Mississippi in the next few years, and many existing plants are expanding, some for the second or third time. Hyundai's \$1 billion plant in Montgomery, Ala., will start out building Santa Fe SUVs and Sonata sedans, employing 2,000 workers when it opens in 2005. By then, Alabama plants will be making 600,000 vehicles a year, or 3.5% of the U.S. market.

The economic benefits extend far beyond the jobs in those assembly plants. For each auto job created by the transplants, 5.5 additional jobs are created in supplier factories or elsewhere in the community, according to a study by CAR. That's because those highly paid factory workers spend more at restaurants and stores and on other local services. That

multiplier effect is increasing as companies such as Toyota and Honda expand their operations here and use more locally built components. A decade ago, the transplants created 4.5 spin-off jobs for every assembly job. Farther north, globalization is working the other way: As Big Three factories import more parts from Mexico and other countries, their contribution to the U.S. economy is shrinking. Each new auto-assembly job creates 6.9 additional jobs, down from 7.8 in 1990.

Still, a job created by a transplant factory in the South is not equivalent to a job at a Big Three factory. Foreign manufacturers, which aren't unionized, pay workers less than their Detroit rivals. Under their labor pacts with the UAW, Auto Workers, for instance, GM, Ford, and Chrysler pay workers about \$25 an hour. At Honda's new Alabama plant, workers start at \$14 an hour and work up to about \$21 an hour in 10 years. Suppliers to the transplants tend to be nonunionized and pay less, too.

At factories such as Mercedes in Vance, where the UAW



BETTER JOBS Mercedes worker Mendez "never thought I'd find a place where I could retire"

attempted organizing a union, management quickly squashed the attempt to keep the workers out. Mercedes, for instance, now pays its workers \$25 an hour, more than UAW workers at its sister company, Chrysler Corp. "Would Mercedes be paying \$25 an hour in wages in Alabama if the UAW wasn't standing outside the gate?" Sean P. McAlinden, director of CAR's Economic Policy Group. "Absolutely not. They wouldn't pay \$12 to \$13 an hour."

That clout is likely to diminish if the UAW can't attract new members. UAW leaders have failed in several attempts over the decade to organize workers at foreign-owned factories. Meanwhile, the union continues losing jobs

to the Big Three. The U.S. auto market can't possibly grow enough to absorb all the new production capacity. With a new transplant factory that opens, other, less efficient factories will have to close. Struggling Ford plans to shutter at least five factories in the U.S. and Canada and downsize another 20 by mid-decade. Chrysler has already cut production 15% by eliminating shifts at most of its North American plants. Even a recently resurgent GM will have to close underutilized factories, analysts say.

The UAW already has seen its Big Three membership drop by 60%, or 420,000 jobs, since 1979. As the number of nonunion workers in the industry grows, the UAW's power to set industry wages, if not its very survival, is in jeopardy. "The union is at a critical point," says UAW organizing President Bob King. "We really have to greatly expand our organizing successes."

It's likely to be an uphill battle for King and the UAW's



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INSURANCE, FINANCIAL SERVICES AND THE FREEDOM TO DARE.

president, Ronald Gettelfinger. One of the primary requirements listed by foreign auto makers when choosing a U.S. factory site is the absence of union influence, says Claude "Buzz" Canup, president of Canup & Associates in Jackson, Miss., a site-selection consultant that has worked with many auto makers. "They might say, 'We don't want to be within 60 miles of an existing unionized plant,'" says Canup. "You

don't want to walk into the hornet's nest if you're looking not to get stung."

Cover Story

NOT YOUR FATHER'S FACTORY

By forcing foreign-based manufacturers to hike their nonunion wages, the UAW helps to level the playing field for GM, Ford, and Chrysler. Not completely, though: Detroit auto makers still have an estimated \$1,600-per-vehicle cost disadvantage vs. the Japanese, according to a Deutsche Banc Alex. Brown Inc. analysis. But it's flexibility, not wages, that gives nonunion transplants a productivity edge, most experts agree.

"Even if they paid union scale and even if their benefits came up, I think they would still be more efficient," says Van Bussmann, Chrysler's former chief economist and now senior vice-president of global forecasting for J.D. Power & Associates Inc.

For one thing, Japanese-owned factories typically build two or more models on a single assembly line. That's especially helpful as auto makers turn out more low-volume niche models. If sales of one model start to wane, they can quickly crank up production of another. But Big Three factories were designed to build large volumes of a single model. All the Detroit companies are racing to make their plants more flexible.

To be sure, U.S. auto makers already have taken big steps to improve productivity. In 1979, it took GM an average of 41 hours to assemble a vehicle; by 2001, that was down to 26.1 hours. In fact, GM's Oshawa (Ont.) factory, which makes Chevrolet Impalas and Monte Carlos, was North America's most efficient last year, says manufacturing consultant Harbour & Associates Inc. in Troy, Mich. But overall, U.S. carmakers still lag behind Toyota, Honda, and Nissan in productivity.

Strict labor pacts have sometimes been a hindrance. In 1999, GM was stymied by UAW objections when it tried to open a more efficient factory near Cleveland—Project Yellowstone—that would have relied on outside suppliers for more subassembly work. Only recently did it win the UAW's cooperation to build a superefficient modular factory in Lansing,

Mich. The plant has a flexible body shop where robots can be reprogrammed quickly to weld together vehicles ranging from cars to SUVs. It can produce the new Cadillac CTS in just 10 hours—as fast as Nissan's U.S.-best plant in Smyrna, Tenn.

Such modular manufacturing techniques are common in the transplant factories. And that can be a big competitive advantage. A cockpit module—the portion of the interior that the driver sees and touches, including the instrument panel and steering wheel—that is pre-assembled by a nearby supplier and then installed as a single component at the assembly plant can shave as much as 25% off the cost of producing the system, according to CAR.

That pre-assembly work is providing growth opportunities for U.S.-based suppliers such as Delphi Corp. and Visteon Corp., which are trying to reduce their dependence on the Big Three. Delphi, a GM spin-off, built a factory five miles from Mercedes' Tuscaloosa (Ala.) plant when it landed a contract to supply cockpit modules for the German auto maker's first SUV, the M-Class. Every 2½ minutes, Delphi workers receive an electronic signal from the Mercedes factory telling them exactly what color dashboard panel to build next and what

features to include, such as a CD player or navigation system. Then the finished modules are sent in batches to the Mercedes plant, where they can be quickly installed. The relationship has enabled Delphi to win more business from Mercedes, both in Alabama and in Europe, which fits nicely with Mercedes' strategy to capture more non-GM business.

A raft of smaller suppliers, fiercely loyal to the new factories, are springing up. Tom Burns, 68, who started cleaning Toyota's Georgetown (Ky.) plant in 1979, is now a partner in a \$10-million-a-year business with T&W Inc., that sup-

WINNERS & LOSERS in the Brave New Auto World

WINNERS

Car Buyers The cost of new cars has fallen steadily since 1998. But the real story is that American cars are finally seriously competing in the arena of design as well, giving buyers a smorgasbord of choices and more standard features.

The South An influx of car factories has been a boon to states such as Alabama, Kentucky, Tennessee, South Carolina, and soon, Mississippi. Workers at 6,300 Alabama jobs get paid up to \$25 an hour, compared with about \$10 an hour in the state's crumbling steel and textile industries.

Foreign Carmakers Foreign manufacturers have grabbed 10 points of U.S. market share from the Big Three since 1995. And by designing, engineering, and building in the world's most profitable market, they can respond more quickly to changing consumer tastes and eliminate risks caused by currency fluctuations.

LOSERS

The UAW The union has so far been stymied in its attempts to organize foreign-owned factories. As more nonunion factories gravitate to the South, the union's clout weakens.

The Big Three Forecasters say GM, Ford, and Chrysler will continue to lose share in the short term, forcing factory shutdowns and blue- and white-collar layoffs. Even after the U.S. market reaches a new equilibrium, Detroit may have lost its lead.

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As transplant factories crank out hot new vehicles, they redefine what constitutes a domestic industry

Honda, Toyota, Nissan, BMW, and Ford with tire-and-wheel assemblies. Given a choice, says Burn, he would work only for foreign-based manufacturers. "They squeeze you, but they're fair," he says. That's not always the case with the U.S. companies, he says. "They want to beat you to death. If somebody comes in one penny cheaper, they'll replace you in a minute." Eroding loyalty could have big consequences for Motown. A

Cover Story

survey last year of 261 big suppliers found they were less likely to share their best technology with auto makers who grind them on price cuts.

CULTURE OF INNOVATION

Even in its darkest days, Detroit has understood the American auto buyer better than anyone: Witness the minivan and the SUV. But as companies such as Toyota, Honda, and Nissan become ever more dependent on North America for their worldwide sales and profits, they are pouring more resources into developing and designing vehicles specifically for Americans. Gone are the days when a company such as Chrysler could ride a single hit product such as the minivan straight to the bank. "In this kind of industry, you have a mindset to defend your core segment," says Wolfgang Bernhard, Chrysler's chief operating officer. "But if everybody is playing offense and you're playing defense, you lose."

After watching consumers flock to striking new foreign models, U.S. auto makers have been recruiting hot designers from European rivals and paying fat salaries to design-school graduates. More important, they're giving designers and marketers a stronger voice in developing new models, and they're lifting design bosses higher in the corporate hierarchy. The result: no more sedans shaped like jelly beans. Detroit is turning out head-turners such as the retro Chrysler PT Cruiser, the Euro-styled Ford Focus, and designs that morph into a cargo hauler.

With profits practically nonexistent for domestic auto makers, the pressure to do more with less is changing the way companies develop vehicles. They've squeezed suppliers about as far as they can. Now, they're sharing more platforms and components across brands. And they're focusing on how to wring out waste and eliminate defects long before a vehicle hits manufacturing. Not only does this reduce production costs, it improves quality. That, in turn, means further savings of hundreds of dollars per vehicle because of fewer warranty claims and incentives. "We've got to be efficient while we're innovative," says Ford Chief Financial Officer Allan Gilmour. "American companies haven't done a very good job of that."

That's how Chrysler, which lost \$2 billion last year, is managing to expand its lineup while chopping \$12 billion, or near-

ly 30%, from its five-year product-development budget. Such as the Crossfire, a sexy two-seat roadster due next year, will add cachet yet didn't bust the budget: Nearly 40% of its components were borrowed from Mercedes.

A BIG WIN FOR CONSUMERS

Former GM Chairman Alfred P. Sloan once boasted that he offered "a car for every purse and purpose." His words describe the U.S. auto industry in 2002. No longer are there just familiar sedans, coupes, and minivans. Consumers choose from an array of multipurpose vehicles. A.J. Teixeira, 33-year-old Washington (D.C.) tech-support specialist, recently looked at seven vehicles before settling on a Subaru Legacy wagon. He and his wife checked out the compact Honda Civic SUV, the spacious Buick Rendezvous SUV, a Kia Sedona minivan, a Honda Accord sedan, and the car-based Toyota Highlander SUV. "Do we want a minivan, a car, or an SUV? We had to choose it down somehow," Teixeira says. "It's overwhelming."

But that's just the start. The number of new models

expected to surge from 40 in 2002 through 2005, to an average of 50 a year, according to Merrill Lynch & Co. That's far more than the 35 models launched in a typical year. Next year should set a record 65 new vehicles.

Moreover, cars keep getting cheaper. Prices have been falling since 1997, and consumers are getting more for their money. Sophisticated safety features such as anti-lock brakes, side airbags, traction control, and stability-control systems are now widely available. Quality is better, too. Since 1980, reliability has improved 77%, according to



ALABAMA Delphi set up shop five miles from Mercedes

Consumer Reports magazine, with Detroit-based manufacturers making the biggest gains. In 1987, GM, for instance, had 180 defects per hundred cars in a J.D. Power quality study, vs. 12 for Toyota. By 2002, in a redesigned survey, GM's quality had improved to 130 defects per hundred cars and trucks vs. 10 for Toyota. This is great news for consumers but expensive for makers pressured to keep product lines fresh even as margins shrink. "Essentially, the customer is deciding who's going to thrive and who's not," says Ron Harbour, president of Harbour & Associates.

All the turmoil is a golden opportunity for Detroit, Delphi CEO J.T. Battenberg III: "The industry is reinventing itself at a time when competition is going to get fierce. But fortunately, it's occurring in an era where there will be more affluent buyers." Detroit will likely have to settle for a shrinking piece of the pie. The industry that emerges will look very different, but may well be stronger. And that will be a good thing for everybody.

By Joann Muller, with Kathleen Kerwin and David W. in Detroit

Continued on page



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HAS THE UAW FOUND A BETTER ROAD?

Although the United Auto Workers has failed to sign up transplant workers, it's having much better luck among the 500,000 or so workers in the largely nonunion auto parts industry. For years, some union leaders wanted to use the UAW's still-powerful grip on Detroit

Cover Story

carmakers to get help organizing the companies that supply components. But little happened. Now, the union is starting to act. In early June, just hours after he was sworn in, UAW President Ronald A. Gettelfinger authorized a carefully planned strike against four Johnson Controls Inc. (JCI) factories that make interior parts for some of the country's best-selling vehicles. It was the opening gambit in a new campaign to reverse the union's sagging membership.

The plan was cunning. The quick two-day strike cost workers little in lost income. But it pinched General Motors Corp. and Chrysler Group by shutting down production of their popular Chevy Trail-Blazer and Jeep Liberty sport-utility vehicles. Worried about lost sales in a profitable segment and eager to preserve good relations with the UAW, GM and Chrysler played an active behind-the-scenes role by leaning on JCI to settle the dispute, say company insiders.

The result: one of the UAW's biggest organizing breakthroughs in decades, says Sean P. McAlinden, a labor economist at the Center for Automotive Research in Ann Arbor, Mich. In addition to raises of up to \$6 an hour, the strikers won a JCI promise not to interfere with UAW efforts to organize some 8,000 workers at the 26 other JCI factories that supply the Big Three. If JCI offers no resistance, the UAW expects to sign up most of them within months. Says JCI spokesman William J. Dawson: The pact "reflects our interests in accommodating the needs of our customers that are represented by the UAW."

The union plans to replicate its strategy at other auto parts makers (table). By putting pressure on carmakers, the UAW hopes to reverse a trend that has cut its parts membership to less than 20% of the industry, vs. more than half in the late '70s. If the plan works, the UAW will become the first U.S. labor group to reunite a big industrial sector. "We're not a strike-happy union, but we're also not afraid to use a point of leverage to support workers who want UAW



BOLD MOVE
Organizing honcho King crafted the strategy that led to a strike at four Johnson Controls plants

representation," Gettelfinger said after the JCI strike.

Despite all the tough talk, it's not clear whether Gettelfinger will follow through on such a bold plan. The strategy is mostly the brainchild of Bob King, the union's vice-president for organizing, who has long pushed for the idea. But Gettelfinger's predecessor, Stephen P. Yoki, always emphasized salaries for current members. Gettelfinger may feel pressure to do likewise when the Big Three's labor pact expires next year.

The UAW's strategy will hold only if it can unionize all the major suppliers in an industry segment. Otherwise, the companies that remain non-

union could use the lower costs to drive out the unionized competition. So King's plan starts with JCI and includes other makers of interiors. Gettelfinger remains willing to utilize the union's clout, the auto parts industry could again become a union stronghold.

By Joann Mullen in Detroit

PRESSURING DETROIT

The United Auto Workers is using its clout with the Big Three to help organize at nonunion auto parts factories. Here are some of its targets:

Data: BusinessWeek

MANUFACTURER/ PRODUCT	WORKERS	CURRENTLY UNIONIZED
DANA Chassis components	70,000	28%
JOHNSON CONTROLS Auto interiors	9,000	20*
MAGNA INTERNATIONAL Auto interiors	11,600	2
TRW Chassis components	14,000	22

*New deal with management could bump that to 90% in 6 months.

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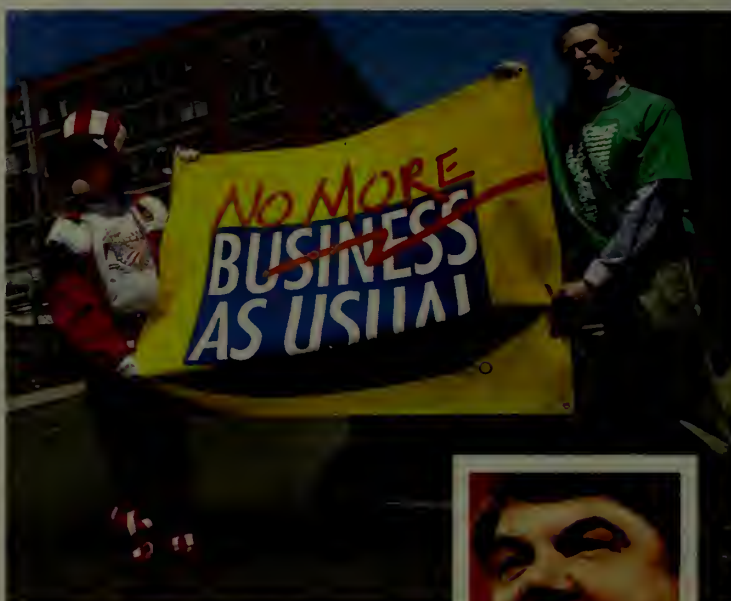
GOVERNANCE

GETTING THE BOSS TO BEHAVE

Big Labor has led the charge for corporate-governance reform

Last year, before there was a whiff of accounting fraud at Enron or WorldCom, the United Association of Plumbers submitted a shareholder resolution at Walt Disney Co. on behalf of itself and three other unions that own about \$93 million worth of stock. The proposal called for the company to stop giving consulting work to its auditor, PricewaterhouseCoopers. Disney asked the Securities & Exchange Commission if it could disallow the resolution, since it dealt with "ordinary business." The SEC, however, ruled in December that it be put to a vote at Disney's annual meeting in February. Even before the vote was held, as corporate scandals mounted, Disney vowed to stop using PwC's consulting services. Then, as the proxies rolled in, the company promised wider auditor curbs. Even so, the resolution won 44% of votes cast—a strong showing.

It was another victory for a group that may be doing more than any to push for corporate-governance reform: Big Labor. Since the early 1990s, unions have used their \$3 trillion-plus in pension assets to prod business to adopt good-governance practices. Labor's goals are largely the same as those of other investors: to maximize shareholder value. Now, the current wave of scandals



has put unions at the forefront of an issue far removed from their usual fight for higher pay. All the malfeasance "has opened up the corporate-governance debate in a way that hasn't happened since the 1930s," says William Patterson, head of the AFL-CIO's Office of Investment.

Labor was well-positioned to take advantage of the new reform mood. Unions submitted 28% of all shareholder resolutions in the 2002 proxy season vs. 18% last year—far more than any other institutional investor, says the Investor Responsibility Research Center in Washington. Says IRRC analyst Rosanna Landis Weaver: Labor "has made superb use of the moment."

Indeed, the unions' reform initiatives are winning more majorities or strong

votes than anyone expected last year (table). Unions submitted resolutions for auditor independence at 33 companies in addition to Disney. Thirteen have moved to new limits and oversight on executive services, while three more are discussing similar changes with labor. Votes have been held at the other end of the scale, with many resolutions garnering shareholder support of 30% to 40%.

Unions have been effective in part because they focus on issues with broad industry appeal and mobilize groups behind them. They were the first to attack Stanley Works' attempt to save tax dollars by moving to Bermuda. When the auditor/consulting issue bubbled up, unions analyzed it fast and jumped on it," says Kenneth A. Bo

SHAKING THINGS UP AT STANLEY: AFL-CIO PROTESTERS AND TREASURER TRUMPKA

head of corporate governance at TIAA-CREF, the team's retirement fund.

Labor also has put its political campaign skills to work. Unions coordinate pressure tactics on each other and build support for like-minded institutional investors.

In its recent bid to knock former Corp. director Frank Savage off the board, the Machinists' national Association of Machinists supported from the California Public Employees Retirement System (CalPERS) and the New York State pension fund among others. Savage was reelected, but 28% of shareholders voted against him, a rare show of dissent in what is usually a perfunctory election.

As the proxy season winds down, labor is gearing up to lobby Congress on new pension and accounting laws. Patterson and others have been meeting with SEC Chairman Harvey L.

pressing for tighter curbs on stock trading by analysts. "We're giving workers a voice in global capital markets," says AFL-CIO Secretary-Treasurer R. L. Trumpka. The voice Corporate America is likely to hear with more frequency.

By Amy Boesman
with Paula Dwyer
Washington

SHAREHOLDERS UNITE

Unions have used their \$3 trillion-plus pension-fund holdings to push for corporate-governance reforms. Some examples of labor activism:

AUDITOR INDEPENDENCE

Construction-union shareholder resolutions at 34 companies call for limits on consulting contracts to auditors. So far, 13 have agreed.

EXECUTIVE PAY

A Teamsters shareholder resolution to let Bank of America shareholders vote on executive severance deals passed by 50.7%.

DIRECTOR ACCOUNTABILITY

An AFL-CIO campaign has prompted 5 of 10 Enron directors to resign board seats at other companies.

THE BERMUDA TAX DODGE

The machinists union helped to force Stanley Works to revote a proxy resolution on management's plan to reincorporate in Bermuda.

Data: BusinessWeek

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AN OVERDOSE OF OPTIONS

Depressed stock prices are prompting companies to issue more options than ever

Stock options were supposed to be the great motivator, letting top management reap a share of the gains they produced for shareholders. They certainly enriched smart execs who cashed them in before the stock market tanked. But investors are getting poorer, not richer, as company after company shatters on the rocks of executive fraud, greed, and incompetence.

Worse may be yet to come. Companies are still issuing options at a furious clip. In fact, 200 of the largest companies are handing them out in amounts approaching 3% of their outstanding shares every year, more than double the pace of a decade ago. The grant rate is headed yet higher as companies try to compensate executives for the lost value of options they received before stock prices fell. Moreover, with shares down sharply, the standard models used to price options show that companies will have to issue more of them to give executives the same dollar value each year.

Though the 3% annual average of option grants may look like peanuts, it could become a large and permanent drag on future share prices. In fact, if the market returns to its historical rate of return of about 10% a year, options will siphon off nearly one-third of company profits by the time they expire in 10 years. Investors will have their pockets picked either by having earnings per share watered down by the additional stock or by corporate spending on

share buybacks to control dilution.

With a big transfer of wealth to management on the horizon, a shareholder backlash is gathering force. Institutional investors have declared war on runaway option grants and the outsize goodies they bestow on corporate insiders. "The trend is really bad," says Patrick McGurn, director of corporate programs at Institutional Shareholder Services, a proxy-vote advisory firm. It comes when

many money managers are bracing for a long period of investment returns below the 18%-plus levels of the 1990s. Says Lisa Rapuano, a mutual-fund manager at Legg Mason Inc., "There's a smaller pie, and executives continue to ask for more of it. We have to be careful on making their share small."

THE BIG BITE

Here's how the executive's favorite perk can hurt other shareholders long-term:

IF...

- A company earning \$1 billion a year sees both its income and shares, now trading at 25 times earnings, rise 9.4% a year for 10 years, and
- The company each year grants executives options for 3% of outstanding shares, and
- Executives exercise all options in the 10th year, and company buys back an offsetting number of shares

THEN...

- Executives make profits of \$5.2 billion from exercising options and selling stock.
- Company spends a net \$5.2 billion on stock and deducts same amount as expense from taxable income.

BOTTOM LINE

- Shareholders are left with just \$3.7 billion, or 54% of the \$6.9 billion of additional income earned by the company above the starting level of \$1 billion each year.



it's starting to happen. Investors voting down a record 23.4% of options vs. 16.2% five years ago, according to the Investor Responsibility Research Center. Some companies are getting the hint: Jones Apparel Group, after a shareholder rebellion, withdrew an in May before it came to a vote. Most aren't going to give up without a fight (p. 114). Companies like options because they appear to be a cost-effective way of paying employees: Unlike bonuses or salaries, most options don't have to be deducted from company earnings as an expense.

One way the conflict plays out could have a big impact on stock prices, insider trust, and companies' ability to reinvest in innovation. If companies voluntarily pare down their compensation packages to better align the interests of shareholders and executives, confidence will rise and so should performance. But if the drive to improve the system fails, shareholders may become even more disillusioned with Corporate America.

Even as the fight un-

The growing pool of options waiting to be converted into shares weighs on stock prices

Folds, shareholders are seeing more and more of the value of their companies slip through their fingers. On average, stock equals 16.3% of large U.S. companies' outstanding shares has been earmarked for employee options, nearly double the 8.3% average a decade ago, according to a survey by executive compensation consultants Pearl Meyer & Partners. Starting with fiscal years beginning after Mar. 14, 2002, a new Securities & Exchange Commission rule will require companies to disclose details of their options overhang more clearly.

Because of the bear market, of course, some existing options seem unlikely ever to be turned into shares because their strike prices are far above today's market. But since almost all options have 10-year terms, they could spring back to life in years to come.

"As companies recover and their stock prices start to improve, these underwater options will come back in the money and automatically dilute earnings," says McGurn.

The existence of so many options waiting to be converted into shares weighs on the markets, acting as a brake on any potential stock price rises. And the overhang is building. Undeterred by poor results, companies keep issuing larger amounts to compen-

sate top brass for the weakness in stocks. The average "burn rate"—options jargon for the pace at which companies issue the securities—is now 2.6% of outstanding shares a year, more than double the 1.08% rate in 1991, according to Pearl Meyer.

The trend will burn investors in coming years as companies turn over a growing share of their returns to insiders. Take a company with a price-earnings ratio of 25 and earnings and stock prices growing at 9.4% a year, the historical return on stocks at constant price-earnings ratios as calculated by Ibbotson Associates. Assume the company grants options representing 3% of its stock in 2002. According to *BusinessWeek* calculations, if executives then exercised all those options in 2012, it would have to pay out 27% of its income that year just to mop up the new stock. And that's after allowing for the tax break the company obtains—equal to the difference between the price executives pay them for the stock and what the stock is worth when the options are cashed. Without that benefit, the exercise would swallow up 44% of 2012 earnings.

Repeat the math over a full decade to capture the impact on each year's profits, and the result is worse (table, p. 112). Management would skim off 46% of earnings added over the 10 years even though most of the gains resulted from little more than keeping pace with the economy. So much for proponents' arguments that options reward outstanding performance.

Institutional investors are hoping that major changes may now occur in executive pay. They'd like to see compensation plans that reward executives for doing more than showing up for work and simply matching broad economic trends. Peter T. Chingos, head of the compensation practice at Mercer Human Resource Consulting, expects companies to begin shifting away from options—for example, to bonuses for

MORE IS LESS—FOR INVESTORS

At some companies options could result in a sharp dilution of equity. Though tech outfits are the most profligate, others are on their heels.

ANNUAL OPTION GRANTS AS % OF SHARES OUTSTANDING*

SIEBEL SYSTEMS	16.5%	QUINTILES TRANSNATIONAL	9.4%
BROADCOM	15.0	LEHMAN BROTHERS	9.4
PEOPLESOFT	10.1	TMP WORLDWIDE	7.5
APPLE COMPUTER	9.4	McKESSON	6.8
RATIONAL SOFTWARE	9.0	MERRILL LYNCH	5.8
NATIONAL SEMICONDUCTOR	9.0	PEPSI BOTTLING GROUP	5.8
NOVELL	8.8	S&P 500 AVERAGE	1.9

*Three-year average

Data: Lehman Brothers Inc., *BusinessWeek*

growth in earnings per share and return on capital that beat industry benchmarks.

But change is likely to remain modest until the big roadblock of inconsistent accounting standards is removed. Current rules effectively penalize most ways of linking pay to exceptional performance. For example, companies must treat options as an expense if their exercise price varies, perhaps rising with an index of the stocks of a peer group. By contrast, the classic fixed-price option is not an expense.

Likewise, when companies pay with restricted shares which executives must hold for a number of years, they must

count them as an expense when they're issued. Despite that, employees love them because they are worth something, even if the stock falls. "In a down market, restricted shares are far more motivating and can retain a person better than stock options will," says Richard H. Wagner, a principal at Strategic Compensation Research Associates.

Indeed, if accounting rules treated all options equally with other forms of

pay, companies would be free to compensation methods based on how well they motivate execs, not what they do to reported earnings. "In exchange for that accounting, we would have a program that is more effective in motivating people and getting financial results," says Wagner.

Perhaps if enough investors convinced executives that they are paying too much for the cost of stock options, corporations will quit blocking a new accounting standard and get on with finding the compensation tools that work best. But until then, the friction of options is only likely to keep growing.

By David Henry in New York

THE CAMPAIGN TO KEEP OPTIONS OFF THE LEDGER

Chalk up another win for Silicon Valley. On June 17, the board of the California Public Employees' Retirement System voted unanimously to set aside a staff recommendation that it should call on companies to deduct from profits the value of stock options that they give to employees.

In April, CalPERS' staff had urged the board to push for expensing options, a position other big institutional investors, such as teachers' retirement fund TIAA-CREF, have taken. But Valley executives, including venture capitalist John Doerr and Marimba Chairman Kim K. Polese, bombarded the directors with calls urging them to vote no.

Doerr & Co. argued that there isn't an accurate way to value options. Moreover, they asserted, forcing companies to deduct options from earnings would make them too expensive, eliminating a vital recruitment tool. Technology Network, an industry political action committee, even got mid-level employees at Intel Corp., Cisco Systems, and other companies to write to CalPERS or testify in person about how options helped them buy a house or support their extended family.

The campaign was just the latest round in Corporate America's all-out campaign to thwart a rewrite of accounting rules for options since the collapse of Enron Corp., Global



THE BATTLE OF GUCCI GULCH

Corporate lobbying keeps thwarting efforts to make companies treat options as an expense. Some of their key victories this year:

- The McCain-Levin bill, which would have forced companies to expense options if they take a tax deduction for the costs, never got to the Senate floor for a vote
- To win industry support for his accounting reform bill, Senate Banking Committee Chairman Paul Sarbanes (D-Md.) deleted a provision directing the SEC to study the issue
- The CalPERS board rejected a staff proposal that the pension fund urge companies to treat options as an expense

Data: BusinessWeek

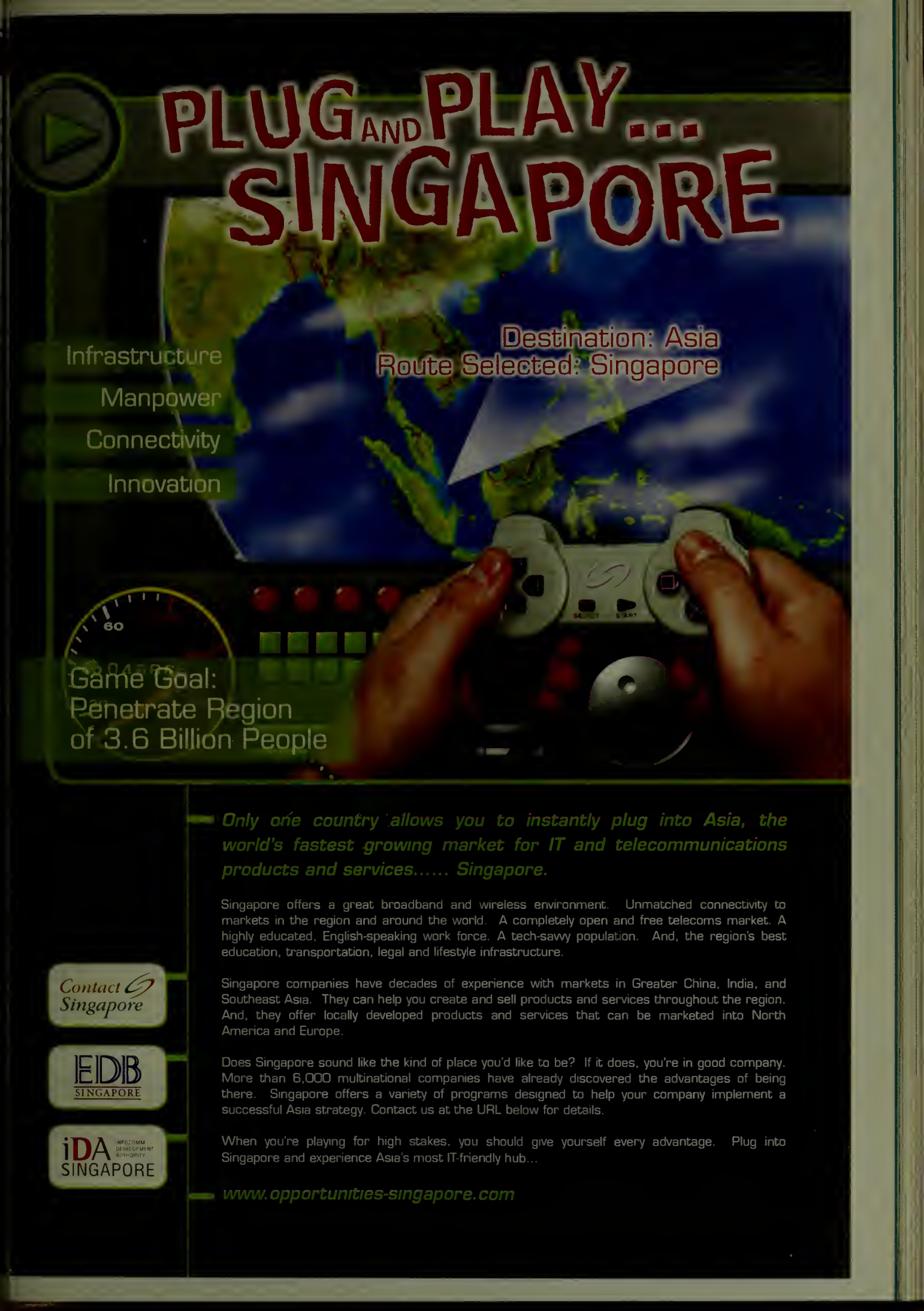
DOERR: *The venture capitalist opposes treating options as an expense.*

Crossing Ltd., and other aggressive issuers of them. In March, lobbyists derailed a bill co-sponsored by Senators Carl Levin (D-Mich.) and John McCain (R-Ariz.) that would have made companies expense options if they take tax deductions when they're exercised. Industry groups opposing the bill—including Financial Executives International and TechNet—wrote to all 100 senators. And in mid-June, tech industry reps even got Senator Paul Sarbanes (D-Md.) to delete from an accounting reform bill a provision directing the Securities & Exchange Commission merely to study expensing options.

Now, the battle is moving abroad. The London-based International Accounting Standards Board is drafting rules requiring options to be expensed. Business groups fear that would rev up support for expensing in the U.S. Dozens of U.S. companies, including Cisco Systems and Motorola Inc., have flooded the IASB with critical letters. However, IASB Chairman David Tweedie isn't persuaded. "Everything I've heard to date convinces me that stock options are an expense," he says.

Some European companies don't want Tweedie to back down. "Especially after Enron, treating options as expenses would provide a form of protection for shareholders and help win back their trust," says Heinz-Joachim Neubürger, chief financial officer of Siemens. While U.S. business may have won a skirmish at CalPERS, it still can't declare victory in the stock-options expensing war.

By Amy Borrus in Washington



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AUTOS

FIXING THE ENGINE TROUBLE AT FORD CREDIT

The carmaker's finance arm is getting back to basics

Ford Motor Credit Co. has long been a reliable cash cow for the No. 2 auto maker. Until, that is, former Chairman Donald Winkler set out a few years ago to turn it into "a global auto finance superpower." Ford Credit boldly plunged into myriad services such as home mortgages and online stock trading, as well as aggressive lending to car buyers with poor credit.

Two years later, Ford Motor Co.'s finance subsidiary has become something of, well, an Edsel. Bad loans have forced it to nearly double its provision for credit losses; in the fourth quarter, the unit lost \$297 million—the first quarterly loss in its 42-year history. Its credit rating has suffered. Says Burnham Securities Inc. auto analyst David Healy: "They lost a lot of discipline. They wrote a lot of bad paper."

Can Ford Credit be fixed? That's the question facing Greg Smith, a 29-year company veteran who has led the finance unit since Winkler's ouster in December, and is charged with leading its overhaul. His marching orders are simple: Make money and support Ford sales. Period. No more online deals or risky cutting-edge stuff. "We're focusing on doing things that we know we can do extremely well," says Smith.

Sounds simple, but the low-key Smith faces a daunting task. An engineer before he joined Ford's financial-services group in 1993, he has to dump the money-losers, streamline operations, collect on existing loans, and tighten standards on new lending, among other things.

Ford Credit's grandiose dreams of growth were part of former Chief Executive Jacques Nasser's plans for diversifying Ford Motor into an array of



SMITH: He has cut back on subprime lending

consumer businesses. Nasser hired Winkler from Bank One Corp. in late 1999. Under him, Ford Credit's receivables shot up 29%, from \$161 billion in 1999 to \$208 billion last year, thanks largely to forays into lending to car buyers with poor credit. Earnings rose 42% in two years, to \$1.5 billion in 2000, but tumbled to \$839 million in last year's recession as fringe borrowers defaulted.

Smith has abandoned Winkler's goal of increasing Ford Credit's portfolio to \$245 billion by 2006, aiming instead to hold it near the current \$206 billion. He's dismantling Fairlane Credit, a Colorado subprime lender. Smith also curbed risky used-car lending, which does little to aid

Ford's new-car business, as well as to buyers of competitors' cars. And he's winding down a mortgage-lending venture with Wells Fargo & Co.

The changes may take a while. Average loan maturities are at 42 months, so Merrill Lynch & Co. analyst Michael Casesa figures it will take Smith three years to burn off bad loans. In the meantime, the company is experimenting with periodic credit-agency checks on riskier borrowers.

Still, some analysts are optimistic. They estimate that Ford Credit's \$2.3 billion of loan-loss reserves at the end of 2001 are "a thin 1.4 times" the \$2.3 billion of credit losses compared with roughly 1.5 times at other consumer-finance companies. "They don't have much cushion against a downturn," he says. Counters: "We're comfortable" with current coverage levels.

Comfortable or not, the unit's cash flow is still tight. The finance unit skipped its quarterly dividend payments to the parent for the last two quarters. "We won't say when they'll resume. The dividend payment for the first three quarters of

2002, Ford Motor contributed \$100 million in capital to its subsidiary. Still, Wall Street was encouraged by a first-quarter profit of \$100 million versus an \$800 million loss at the parent. That lagged the year-ago quarter but was a marked improvement from 2001's fourth quarter. One sign: Losses as a percentage of receivables in the U.S., although historically high, slowed to 1.4% in the first quarter from 1.76% late last year.

Not dramatic—but an indication it may be pulling out of the breakeven lane. Ford Credit may well become a more consistent if unexciting again.

By Kathleen Kerwin in Detroit

GREG SMITH'S TUNE-UP AT FORD CREDIT

How the auto maker's new boss aims to fix its troubled finance arm:

Data: BusinessWeek, Ford Credit

STRIP IT DOWN Ford Credit branched into online brokerages, mortgages, used-car loans, subprime and commercial lending. Now it's going back to financing sales of Ford vehicles and dealer loans.

CLEAN OUT THE GUNK To clear its books of bad loans and delinquencies, the company is tightening lending standards, monitoring its portfolio better, and stepping up collections.

RUN IT LEAN A deteriorating credit-rating outlook has raised borrowing costs. Smith will maximize securitization of loans to cut dependence on expensive commercial paper as a source of funds.

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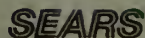
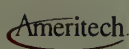
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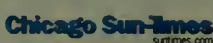
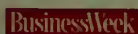
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MOVIE THEATERS

A HOLLYWOOD ENDING FOR MULTIPLEX OWNERS

Attendance is rising just as chains have cleaned up their debt

For theater-chain owners in the past few years, life has been a cliffhanger. Spurred by easy money and swept up by the media-consolidation craze, they went on buying sprees, snapping up smaller chains and piling on debt to build multiplexes on what seemed like every street corner in America. By last year, four of the largest U.S. chains were in Chapter 11, including such well-known names as Loews, United Artists, and Regal. "It was our version of the perfect storm," says Peter C. Brown, CEO of AMC Entertainment Inc., which dodged bankruptcy but closed 30 theaters and slashed capital expenditures.

But now it looks as if chain owners might close out the year with a Hollywood ending. The hottest box office in years is driving up attendance this summer just as many theater chains are emerging from bankruptcy with scrubbed balance sheets. Suddenly, the economics have never been stronger in the world of sticky floors. Attendance so far this year is running 15% ahead of last year, says box-office tracking firm Exhibitor Relations Co., at a time when there are 1,200 fewer theaters than in 1999. Box-office sales are up by 19% so far this year, to \$4.54 billion.

Longer lines this summer, like those for *Spider-Man* and *Star Wars: Episode II—Attack of the Clones*, are giving theaters leverage to raise ticket prices by an average of 5%, to as much as \$10.50 in high-traffic areas such as New York City. So while advertising woes have savaged the media giants, theater

chains are enjoying their moment in Wall Street's sun. AMC's shares are up 20% so far this year, to about \$14.

Other theater chains owe their second act to the bankruptcy courts, which allowed them to wash away mountains of debt and onerous leases. The chains overbuilt and borrowed heavily in a misguided attempt to get larger, figuring that the hot box office of a few years ago would keep growing. By 2000, there were 37,000 screens in the U.S., one-third more than five years earlier, even as movie attendance had begun to slide. Operating margins, never huge, shrank, and debt calls got tougher to meet.

"There were too many un-

derperforming theaters and a lot of debt we couldn't swallow," says Michael Durant, CFO at Carmike Cinemas, which came out of bankruptcy in January after closing 136 theaters.

Now, theater chains are showing new life. Carmike's operating margin rose 13% in its most recent quarter, up from 12% a year ago. That boosted its stock price sevenfold, to about \$24, from its post-bankruptcy price of \$3.50 a share. The hot market for these stocks allowed the chains to raise equity to pay down debt. Cinemark Inc., a Plano, Texas, chain with 3,000 screens, has announced it will raise \$184 million to pay down its debt.

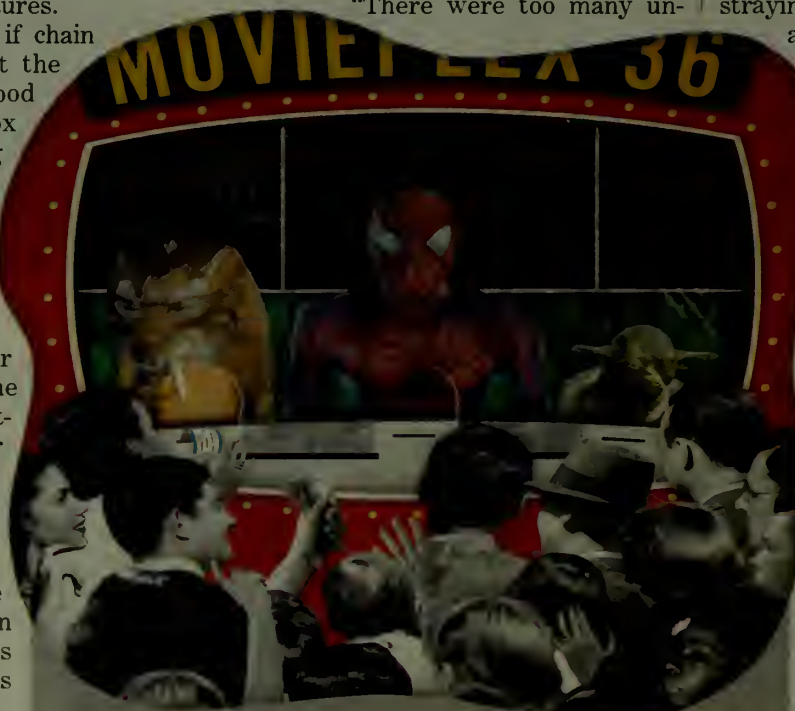
The improving picture lured investment by billionaire Philip F. Anschutz, who paid cents on the dollar to buy Regal Entertainment, and Edwards chains to form the nation's largest theater outfit. Its initial public offering opened on May 9, Regal Entertainment stock shot up. It now trades at around \$15.

The turnstiles are likely to keep turning, at least for a while. In the post-September 11 world, folks are straying far from home, making

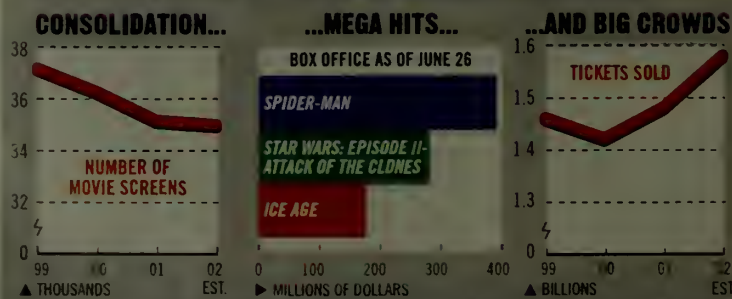
theaters a cheap option to long trips. With more likely blockbusters due later this year, such as sequels to *Harry Potter* and *The Sorcerer's Stone* and *The Lord of the Rings*, box-office sales are expected to surge. "We're seeing a \$9.2 billion this year, a 15% jump," says Exhibitor Relations President Paul Garabedian. Better yet, theater owners, Hollywood studios are starting to turn out more family-oriented movies, which are more kids dragging their parents to the movies. It also doesn't hurt that studios are spending more on market potential, helping to drive traffic to the theaters.

Still, the chains depend on Hollywood to get the hit formula right. And efforts to find new revenue sources have been largely unsuccessful. Some companies are using their theaters for business conferences. Others are experimenting with booking in sports or live events. "We tried a Destiny's Child concert and got six folks in Kauffman City," says AMC's Brown. "We're still searching for alternative revenues." Until then, movies are the hot ticket.

By Ronald Groves
Los Angeles



WHY THEATER CHAINS ARE PROFITING





The real disaster occurs when you're not prepared for one. It's a lesson you

don't want to learn the hard way. Then again, it's not every day that a serious hurricane makes landfall at your data center. But after being forced to brave the fury delivered by "the storm of the century" in order to prevent total loss of mission critical data—the folks at the IT service center of Mitsubishi Chemical America, Inc. knew they needed a backup plan.

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INSURANCE

BUFFETT JUMPS IN WHERE OTHERS FEAR TO TREAD

Berkshire Hathaway starts underwriting terrorism policies—and investors approve

Warren E. Buffett has seen the future of America's security, and it is a scary sight indeed. Buffett, chairman and CEO of Berkshire Hathaway Inc., made headlines at his company's annual meeting in May by predicting that terrorists one day will detonate a nuclear bomb on American soil. "It will happen," he said.

Despite his dire prophecy, Buffett was in exceptionally good cheer throughout his shareholder weekend. So extreme a disconnect between message and mood would be unseemly in a government official. But Buffett is a businessman, and he believes that his company is well-positioned to profit from the chaotic post-September 11 market in terrorism insurance. "We're selling more terrorism coverage than anybody," he told his investors, "but it does not endanger Berkshire Hathaway."

Since the World Trade Center was destroyed, Berkshire has written a series of large policies extending terrorism

A PORTFOLIO OF HIGH-PROFILE RISKS

A selection of policies underwritten by Berkshire since September 11

- ▶ 2002 World Cup, cancellation coverage
- ▶ Chicago's Sears Tower, \$500 million property damage
- ▶ South American refinery, \$578 million property damage
- ▶ Several international airlines, in a pool with Allianz
- ▶ North Sea oil platform, property coverage
- ▶ Extremus AG, \$380 million, a new anti-terrorism insurer backed by the German government

Data: Berkshire Hathaway, BusinessWeek

coverage to some of the highest-potential targets around. The 2002 World Cup, the world's biggest sporting event, might have ended before it started if not the Sage of Omaha agreed to insure its sponsor against losses resulting from cancellation. Berkshire repurchased French insurer AXA Group, which terminated its cancellation policy after September 11. Buffett's company wrote a \$500 million policy on the story Sears Tower, North America's tallest skyscraper.

With most reinsurers running scared, terrorism coverage is hugely expensive, with companies paying 5% to 30% of a policy's face value. Thanks in part to Buffett's willingness to go where his competitors fear to tread, Berkshire's reinsurance business posted improved results during the first quarter of 2002, with its disappointing German Reinsurance subsidiary turning its quarterly underwriting profit since September 11. Analysts predict that rising reinsur-



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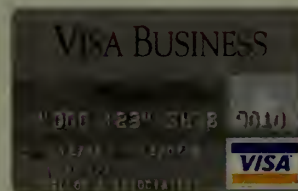
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earnings will continue to buoy Berkshire Hathaway, but only if it can dodge the colossal land mine that lurks somewhere just under the surface of the global insurance industry: the next terrorist catastrophe.

Investors seem to be giving Buffett the benefit of the doubt. Since bottoming on Sept. 19 at \$61,400, Berkshire's A shares have risen to \$66,700—a gain of nearly 9%, compared with a 5% decline in the Standard & Poor's 500-stock index during this period. Berkshire made huge profits over the years insuring against damage caused by hurricanes, earthquakes, and other "super-catastrophes." But as Buffett acknowledges, the well-honed science of predicting natural disasters is of little use when it comes to terrorism, with its abbreviated history and human X factor. "It is not quantifiable," Buffett says flatly. How then can he be so certain that Berkshire is safe in a world shadowed by terrorism?

Buffett's confidence is rooted in a mighty balance sheet. Even after booking a pretax underwriting loss of \$2.4 billion on the WTC disaster, Berkshire still boasts a robust shareholder's equity of \$60.5 billion. "Can Buffett handle it?" asks Standard & Poor's analyst Frederick Loeloff, responding to a question about Berkshire's terrorism exposure. "If a BB company was writing terrorism insurance, I'd have some concerns. But Berkshire is AAA"—S&P's highest credit rating.

What's more, September 11 did indeed prompt Buffett and the top execs at his two reinsurance subsidiaries—National Indemnity Co. and General Reinsurance—to think much more carefully about how to define the risks they insure. It actually occurred to Buffett in the months leading up to September 11 that large-scale terrorism losses were a growing threat, but he did not factor this realization into Berkshire's underwriting decisions. "I violated the Noah principle: Predicting rain doesn't count, building arks does," Buffett admitted in his annual shareholder's letter. "I consequently let Berkshire operate with a dangerous level of risk."

This failing was hardly Berkshire's alone. It will take years to tote up the damages from September 11, but insurers already have booked losses of

\$26 billion and the final tab easily could double. In the typical natural disaster, property damage accounts for almost all insurance loss. However, the claims from the WTC attacks come from many different types of coverage, with property accounting for 27% to 30% of total losses, and business interruption and worker's compensation for most of the balance.

Before September 11, terrorism insurance per se did not exist in the U.S. Berkshire and its rivals unwittingly provided coverage at no extra charge by

much as 60% of the company's \$1 billion loss on the World Trade Center was a product of unwitting aggregation. Obviously, insurers now know a hijacked airliner can be made a bomb that creates horrendous business interruption and worker's compensation. But what previously unimaginable aggregations will surface in the next catastrophe? "Everyone is thinking through these issues," Jain says. "There are no easy answers."

Buffett and crew generally find it hard to hedge the new terrorism risk



SAGE OF OMAHA
Buffett and his crew have found ways to hedge the new risks they're taking on. With the Sears Tower, for example, Berkshire isn't on the hook until losses exceed \$500 million

take on. With the Sears Tower, Berkshire is not on the hook until total losses exceed \$500 million. Similarly, the million worth of property coverage Berkshire extends to a South American refinery does not kick in until damages exceed \$1 billion. Berkshire apparently doesn't take the risk of World Trade Center cancellation alone. Buffett no doubt finds comfort in knowing

that this liability expired when the terrorist tournament ended. In April, Berkshire joined with Allianz and 10 other insurers to offer terrorism insurance to airlines. The Allianz-administered pool will cover a plane for as much as \$1 billion or a line up to \$2 billion a year, but the policy automatically terminates after major events resulting in losses. Berkshire also is participating in Extracure, a new terrorism insurer in Germany. Berkshire will be liable for \$380 million, but the company is part of a \$1.4 billion pool that will be tapped only if the U.S. government is exhausted first.

In the U.S., Congress is now considering legislation that would limit the insurance industry's exposure to terrorism losses by shifting most of the potential liability to the government. Most insurance executives, but Buffett strongly favors federal intervention. Berkshire's CEO has said that he is "perfectly willing" to again lose \$2 billion on a single catastrophe under the "close-to-worst case" that Buffett envisions, a large-scale terrorist attack on America could inflict \$1 trillion in damage. "Only the U.S. government has the resources to absorb such a blow," Buffett warns.

The key word here is "knowingly." Alice Schroeder, who follows Berkshire for Morgan Stanley, estimates that as

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By Anthony Bianco in New



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Are You Overstuffing Your 401(k)?

Many workers would reap tax benefits from smaller contributions

BY PETER COY

You've heard it a hundred times: "Max out your 401(k)." Since contributions come out of pretax income, the 401(k) is supposed to be the perfect tax-sheltered way to save for retirement. Washington is such a believer that it keeps raising the maximum individual contribution: It will hit \$15,000 by 2006. Plus, workers 50 and over can make additional catch-up contributions, reaching \$5,000 a year by 2006.

But the tax treatment of 401(k)s isn't as advantageous as it first appears. For that reason, contributing the maximum amount may not be the best idea for all workers. In fact, economists Laurence J. Kotlikoff of Boston University and Jagadeesh Gokhale of the Federal Reserve Bank of Cleveland argue that many workers would do better by switching contributions from their 401(k)s to other accounts.

The problem is that while postponing tax-

able income gives a break now, it increases your future taxes on payouts from 401(k)s during retirement, since they will be taxed as regular income. In contrast, contributions to tax-sheltered held investment accounts are taxed as ordinary, unsheltered income. The (lower) capital gains rate when sold. A 401(k) could generate much more fully taxable income than it pushes into a higher bracket.

It will also subject more of your Social Security benefits to income taxes. Even the praised feature of the 401(k)—that it reduces your current taxable income—has a small drawback. If it pushes you into a lower tax bracket, it will reduce the value of your mortgage deductions while you're young and still paying mortgage interest.

Kotlikoff and Gokhale conclude that Americans should stop regarding the 401(k) as their primary vehicle for retirement savings. They find that most people should contribute only 4% to 6% of their pay to their 401(k)s. The national average for plan participants is just 7%, and many people contribute far more. While, they say, people should save much more than they do now in ordinary, unsheltered investment accounts—about 17% of pretax income for household incomes over \$100,000.

Kotlikoff and Gokhale did a customized version of their study for BusinessWeek Investor ESplanner, a detailed financial-planning program published by Economic Security Planning, which Kotlikoff is president. (The \$65 program

which requires a fair amount of data is available through www.esplanner.com.)

For starters, they took the case of a hypothetical married couple, age 25, earning equal salaries, who plan to have two children by age 30 and send them both to college. They assume the couple's income will rise 3% a year after inflation until retirement. They also assume a 3% employer matching contribution. They figure that the couple will earn 6% after inflation on their investments, although the rates are similar when lower or higher rates of return are plugged in.

Their conclusion: Contribute at least up to the level at which your employer makes matching contributions. But beyond that, watch out. Kotlikoff and Gokhale find that if their 25-year-old couple has a household income of \$50,000, each spouse should put in just 4% of pay. From \$150,000,



100 in family income, the right level is in the range of 5% to 6%. It's not until family income reaches \$300,000 that each spouse should maximize at \$11,000 each, which for them is a 9% contribution rate. (The program assumes that their companies' plans allow contributions to go that high.)

That's for a couple just starting out. Let's say the same couple is 45, earning no more than \$100,000 combined, and both spouses have been contributing 13.5% a year since age 25. ESPlanner indicates that they should stop making contributions altogether.

Instead of overstuffing the 401(k), ESPlanner recommends that families save more outside it. For example, Kotlikoff says that a Roth IRA is a far better deal than a 401(k) for people whose incomes allow them to qualify. (The current income ceiling is \$95,000 for individuals and \$100,000 for couples.) While Roth contributions made with aftertax income, distributions in retirement are tax-free. Kotlikoff says workers should ask their employers to make contributions to a Roth IRA in place of the company match. "If we're inducing people to save in 401(k)s on the basis of tax savings that aren't there, that's wrong," he says.

It's not that you're not convinced by Kotlikoff's argument and you still want to max out your 401(k). In that case, at least be sure to do it the way that gets you the maximum possible match any month. If you set the percentage of pay too high, you could hit your ceiling at the end of the tax year. After that, you won't be able to make any more contributions. Because you're not making contributions, the company will stop making matching contributions. You'll get less free money from the company over the year than if you had contributed a smaller percentage of your salary and hit the annual limit at the end of December.

Take an example that assumes you can contribute up to the IRS ceiling. Your pretax income is \$10,000 a month. You contribute 11%, or \$1,100, to your 401(k). At that rate, you reach the IRS limit of \$11,000 at the end of October. The company matches the first 3% of your contributions, amounting to \$330 a month. But in November and December, you make zero contributions, so you get zero match. If you had

A Midyear Adjustment

Problem Suppose you earn \$120,000 a year and plan to contribute the \$11,000 maximum to your 401(k). Either because you're overcontributing or because you got a bonus that you hadn't planned on, you've already put \$8,000 in the plan. It looks as if you'll max out in October and miss two months of the company's match. You need to readjust your contribution rate.

Formula (Maximum minus year-to-date contribution) = $\frac{\$3,000}{\text{Number of months left in the year}} = \frac{\$3,000}{5} = \$600 \text{ per month}$

Solution Reduce your monthly 401(k) contribution to \$600, or 6% of pay, to get the plan back on track.

contributed 9% a month instead of 11%, you still would have nearly maxed out your contribution by yearend: \$10,800. Plus, you would have gotten two more months of matching—a free \$600.

If you think you might be overcontributing, it's not too late to fix things (table). Most 401(k) plans allow employees to change their contribution rates at least once a month. Doing a little arithmetic could earn you hundreds or even thousands of dollars.

Again, though, that's assuming you want to contribute the maximum to your 401(k). Kotlikoff and Gokhale make a case that a 4% to 6% contribution rate is the right level for most two-income families. There are other considerations, too. For instance, do you have a cash cushion equal to at least three to six months of living expenses? If not, save up before you raise your 401(k) contributions.

We've all been bombarded with advice about where to invest our 401(k)s. It's time to think more about how much to put into them in the first place. ■

Why the Max May Be Too Much

For many families, saving the highest possible percentage of pay in a 401(k) account could depress lifetime spending. Here's why:

By raising your retirement income, you increase the share of your Social Security benefits subject to income taxes.

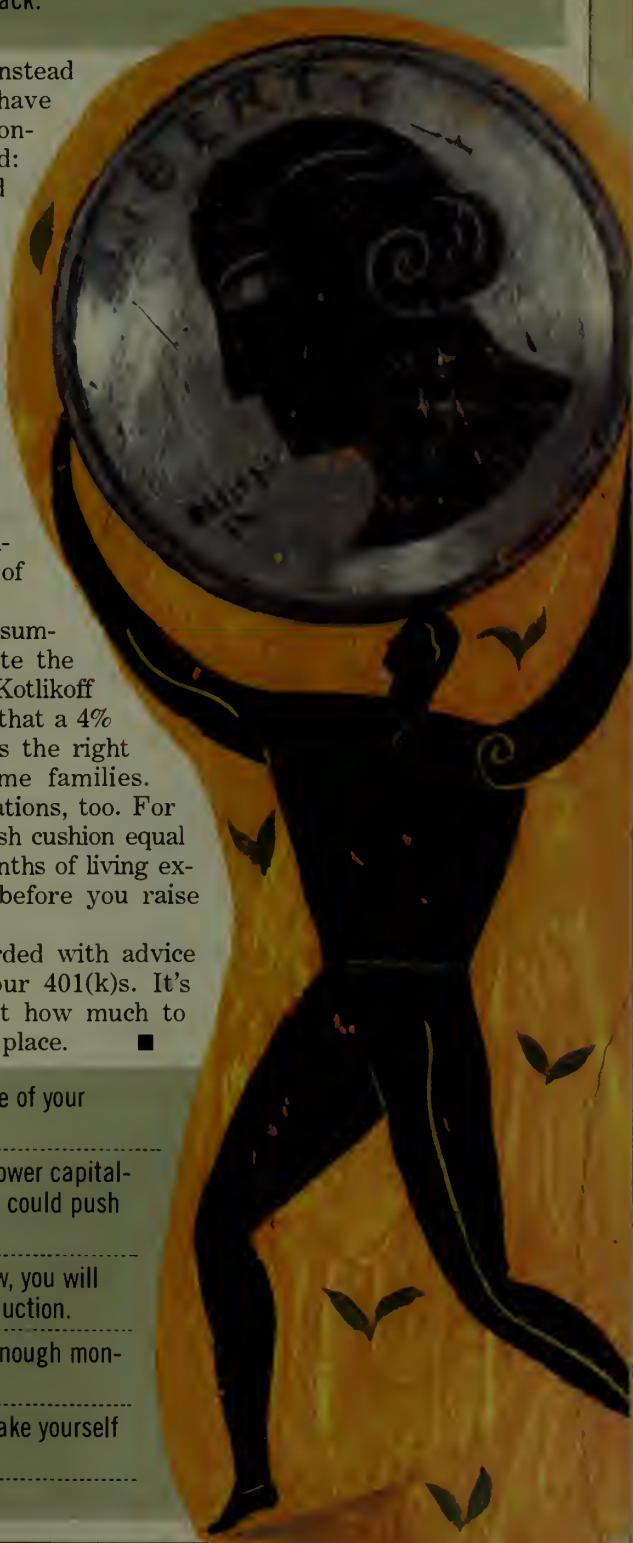
You will have to pay regular income tax rates—not the lower capital-gains rate—on all 401(k) withdrawals. Plus, the income could push you into a higher tax bracket.

If 401(k) contributions put you in a lower tax bracket now, you will get smaller tax benefits from your mortgage-interest deduction.

If you put too much into your 401(k), you may not have enough money available for emergencies.

Some people save too much. It doesn't make sense to make yourself rich in old age by making yourself poor in youth.

Data: Economic Security Planning Inc., *BusinessWeek*



"Schwab plans conflict-free system to set stock ratings."

- USA Today, May 17, 2002

"Is Schwab the financial institution of the future?"

- Barron's, May 27, 2002

"...independence from Wall Street is now considered a competitive edge...."

- Los Angeles Times, May 19, 2002

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- BusinessWeek, June 3, 2002

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a system that helps you decide what to sell as well as what to buy.

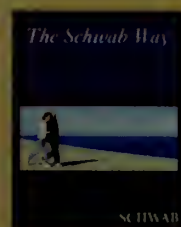
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Cash-Flow Hocus-Pocus

This seemingly simple number can be anything but straightforward

BY ANNE TERGESEN

Many investors believe that cash flow is relatively immune to the accounting games that companies have used to pump up earnings. Well, no more. WorldCom's shocking disclosure on June 25 that it inflated not only its earnings but also cash flow for the past five quarters put an end to that assumption. But while the telecom carrier, now teetering on bankruptcy, will be remembered for its large-scale misrepresentation, it's not the first company to engage in such maneuvers. Indeed, companies have found "many opportunities to manipulate cash flow to shed a more favorable light on themselves," says Charles Mulford, accounting professor at Georgia Institute of Technology.

Much of the manipulation is aimed at pumping up cash flow from operations—the first and most scrutinized of the three sections in the "consolidated statements of cash flow" that follow the income statement and balance sheet in corporate financial reports. (The two other sections report on cash raised or used through investing and financing activities.)

Management has an incentive to make its operating cash flow look good: Wall Street pays a premium for the stocks of companies whose core businesses generate prodigious amounts of cash. Indeed, investors often look down on companies that can raise cash only through financings, such as debt offerings, or investment-related activities, such as asset sales. After all, they can't sustain themselves indefinitely that way.

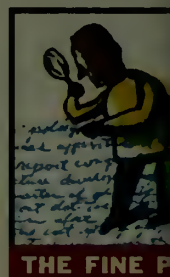
If you only look at cash from operations and take it at face value, you're not getting the whole picture. So in this installment of *The Fine Print*, a series examining financial statements and other corporate documents, we focus on ferreting out cash-flow trickery. Of course, it's not always obvious when companies play fast and loose with the numbers.

In the WorldCom case, for example, "nothing in the financial statements that tip you off," says Doug Carmichael, accounting professor at Baruch College. In many instances, though, there are warning signals.

One way companies boost operating cash is securitizing—or selling—their accounts receivable. These are the bills customers owe. In selling receivables, a company speeds its collections, taking into its coffers immediately the cash it would normally collect in the future. (There is a drawback. To sell those receivables, the company will have to accept fewer dollars than had it waited for the customers to pay.)

This is not necessarily a problem. Selling receivables can be a legitimate cash-management strategy. If the receivables increase each year at the same rate as revenue, the impact on the cash-flow statement is minimal. But when a company starts or steps up a securitization program, it can create the impression that the operating cash flow in that year is better than it really is.

To see why this is a problem, consider Oxford Industries, an Atlanta apparel company. In 2000, its operating cash flow more than doubled to \$74.4 million, from the year before. According to the company's cash-flow statement, the boost to cash flow came from a decline in accounts receivable, which is what happens when customers pay their bills. It sounds impressive, but Oxford's footnotes reveal that the surge in cash flow was driven by an \$80.5 million increase in receivables. Although you could get the impression that Oxford had improved its operations, the apparel maker actually did little more than accelerate collections. Take out the impact of the one-time boost, and Oxford's 2001 operating cash flow would have been negative.



THE FINE PRINT



Software quality ↑ 80%

Developer productivity ↑ 300%

ROI ↑ 1400%

Testing time ↓ 95%

Development cycle ↓ 66%

Lump in throat ↓ 100%



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be liberated

Companies can also keep their operating cash flow high by the way they account for outstanding checks. Witness Aviall, a Dallas manufacturer of aviation parts. In 2000, Aviall showed positive operating cash of \$7.7 million, up from a negative balance of \$12 million in 1999. A big reason for the improvement: an increase in Aviall's accounts payable, or the amount it owed its creditors. (When a company delays payments to creditors, its cash balances rise.)

Still, in Aviall's case, much of the cash it claimed to have at its disposal was actually en route to creditors. In fact, in the first footnote in its 2000 10-K, Aviall reveals that it had already written checks for \$19.7 million—or about four times the \$4.87 million in its cash coffers. Because the checks had yet to clear, the company

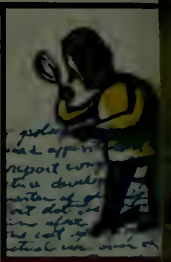
Another dubious source of operating cash is securities trading. Although GAAP rules allow cash raised by securities sales into the operating section of the cash-flow statement, it still comes from activities unrelated to the core operations of most businesses. As such, when gauging a company's underlying health, it should exclude it from operating cash.

To see why, look at manufacturer WHX. First quarter of 2001, the New York City company's cash-flow statement showed that operations produced cash of \$6.3 million. A closer inspection reveals that \$4.76 million derived not from making steel and other products but from short-term investments and borrowings to finance more securities purchases. In a similar manner, the company's operating cash for the first quarter of this year would have been a cash deficit without a \$67.3 million in cash from playing the market.

WorldCom and other companies have also been able to give their operating cash flow a lift by capitalizing expenses. This maneuver boosts the bottom line. Why? When a company capitalizes costs, it creates an asset on the balance sheet and spreads off the costs of creating that asset gradually over annual installments, instead of all at once.

How can capitalization boost operating cash flow? Normally, as a company spends money to produce goods, it deducts those costs from income and thus, operating cash flow. But if a company capitalizes certain costs—the costs of notes to annual reports are a good place to look to see if this is happening—cash that goes out the door is considered an investment in an asset. As such, it is recorded on the cash-flow statement as a deduction to cash flow from investing activities. While the company's operating cash—what you get by adding the numbers from all three sections of the cash-flow statement—remains the same, its cash flow from operations is untouched. As a result, its operating cash flow will look better than companies that do not capitalize.

As the WorldCom scandal has taught investors, cash flow is as vulnerable to manipulation as net income. So before using it as a measure of financial health, you have to check the practices that mask weak performance and produce one-time gains.



THE FINE PRINT

Pumping Up Cash Flow

MANEUVER	WHERE TO LOOK	HOW IT WORKS
SELLING ACCOUNTS RECEIVABLE	Footnotes	By selling the bills customers owe, companies accelerate their cash collections.
CLASSIFYING OUTSTANDING CHECKS AS ACCOUNTS PAYABLE	Footnotes	The checks are gone. But because they haven't been cashed, they are counted in Accounts Payable—which inflates operating cash.
TRADING SECURITIES	Cash-flow statement	For nonfinancial companies, counting proceeds from securities trading in operating cash can make operations look better than they really are.
CAPITALIZING CERTAIN EXPENSES	Cash-flow statement, footnotes, and balance sheet	Capitalized costs are deducted over many years instead of when incurred. If companies capitalize what should be an expense, operating cash will look better.

was able to take advantage of generally accepted accounting principles (GAAP) that allow overdrafts to be lumped into accounts payable. So, instead of reducing Aviall's operating cash, the large balance of outstanding checks actually inflated it.

As Aviall's creditors cashed its checks, the company's operating cash balance turned negative. In 2001, Aviall reported an operating cash-flow deficit of \$93.4 million. Of course, anyone who had subtracted the rise in overdrafts in 2000 from Aviall's seemingly strong 2000 operating cash flow would have been spared this nasty surprise.

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The Skinny On Teeny Cameras

Pocket-size digital shooters are now ready for prime time

BY LARRY
ARMSTRONG

Sure, you love your digital camera, with its ability to let you see your pictures as soon as you shoot them and delete your mistakes before anyone else sees them. But if you're like me, it's rarely within reach for those fleeting moments when you want it most. Instead, it's usually stashed away in a drawer or the glove compartment of your car.

Maybe it's time to treat yourself to another digital camera, one that slips easily and unobtrusively into a pocket. They shouldn't be hard to find: Since the beginning of the year, a number of manufacturers have introduced a dozen or so ultracompact models.

In recent weeks, I have played with eight of them with an eye toward seeing whether their diminutive size makes up for the compromises in features and picture quality. No megabuck, megapixel cameras these: They range in price from \$40 to around \$350. A few are not much more than glorified Webcams, those cheapie cameras you often see sitting on top of computers. And none of them could handle a resolution more than 2 million pixels, a far cry from the 5- and 6-megapixel top-of-the-line—but big and bulky—models. Still, 2 megapixels is good enough to turn out a respectable 5 x 7 inch glossy if your medium of choice is print rather than e-mail.

Best of all, most passed the ultimate test: my shirt pocket. They had to fit comfortably without making the pocket bulge or the shirt front droop. Oddly enough, one that failed was Canon's Digital ELPH, which kicked off the compact-camera trend two years ago. The current ELPH, the \$350 PowerShot S2000, is a full-featured digital camera with a 2X optical-zoom lens, a rarity for these minis. With its elegant stainless-steel body, it weighs in at close to a half-pound, the heaviest of the lot. It was the weight

and squared-off corners that made for an uncomfortable shirt-pocket fit.

If you never turn your pictures into prints, you may be happy with such low-end models as SiPix' \$40 StyleCam Blink or Logitech's \$130 Pocket Digital. At a resolution of 640 x 480 pixels, they're designed mainly for snapping shots destined for posting on Web pages or e-mailing to family and friends. Picture quality is so-so: I noticed a distinct bluish cast to many of my photos. The cameras are basic point-and-shooters with no slots for memory cards, and no liquid-crystal display for getting an early peek at your images: You have to download them to a computer to see them.

But the cameras will store hundreds of shots. And because there's no power-hungry LCD play, battery life isn't a problem. The Blink takes a single AAA battery; the Logitech model

has a built-in battery that recharges whenever the camera is plugged into the computer. (Like these cameras, both hook up to the computer via a USB cable.)

Both are six-tenths of an inch thick and weigh less than



**SIPIX
STYLECAM
BLINK**

RETAIL PRICE \$40

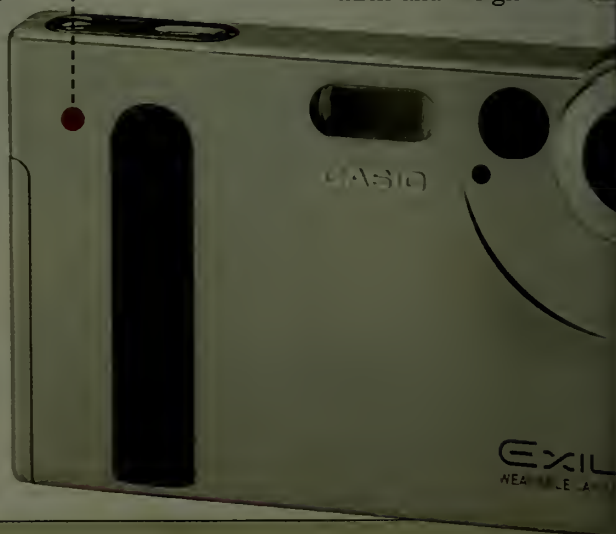


**LOGITECH
POCKET
DIGITAL**

RETAIL PRICE \$130

**CASIO
EXILIM
EX-S1**

RETAIL PRICE \$300



All cameras shown
are actual size

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\$300

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The cheapest models offer no flash, additional memory, or picture preview. Still, they are perfect for uploading quick snaps to the Web

ounces. The Blink, in fact, at two inches square, can easily get lost among the keys and coins in a pants pocket. The camera I found the most fun to carry was the near credit-card-size Logitech because of its worry-free battery and, with its brushed aluminum case, its eye-catching good looks. But you wouldn't want it as your only digital camera, the one you pack for that once-in-a-lifetime photo safari in Kenya.

Another inexpensive camera I like a lot is BenQ's \$100 DC1300. It has the same basic dimensions as Canon's PowerShot, but because it's plastic, it's less than half the weight. It captures 1.3 megapixels with a click of the shutter, so you can print out high-quality 3-by-5-in. or 4-by-6-in. photos. Although it has a flash, it's still a bit stripped-down, lacking a liquid-crystal display for instant gratification, for example. The biggest flaw? The inexpensive plastic lens introduces a lot of distortion unless you're shooting your subject head-on.

The next step up takes you into serious photography—and to the \$300 to \$350 price range. The 1-megapixel Casio EXILIM EX-S1, or the 2-megapixel Canon and Minolta Dimage X models with zoom, are no-compromise digital cameras, just smaller than most. They have bright, 1.6-inch displays on the back, slots for memory-expansion cards, and plenty of manual controls for savvy shutterbugs.

The \$300 Casio has the same credit-card shape as the Canon model, but at a scant half-inch, it's half as thick. Its body is shiny stainless steel, which tends to pick up fingerprints. The \$350 Minolta Dimage is squarer and thinner than the Canon, more like a deck of playing cards. Here's an interesting twist: Its 3X zoom lens, instead of protrud-

ing horizontally the front when the camera is turned, is engineered to fit snugly within the body to make the camera thin.

The downside of these models is battery life. You can only shoot for a couple of hours—you use the display instead of the optical viewfinder for framing your pictures. And looking at them after you have shot the pictures keeps the size down, each of the three cameras uses a thin, rechargeable lithium-ion battery. You really need to carry a spare, and that adds \$40 to \$50.

I looked at two other small, 2-megapixel digital cameras: the Fujifilm FinePix 30i and the Toshiba PDR-T10, each \$300. Call them pocket cameras. They're an inch thick, like Canon's ELPH, but more than a half-inch thick.

The Toshiba is particularly innovative, with only two buttons: on/off and the shutter. All other options are controlled on the LCD touch-screen. Fashionistas will like the interchangeable lens plates (four for \$29), just like the ones available for cell phones. Still, for \$50 more, I would choose the smaller Canon or Minolta models. Optical-zoom lenses make it much easier to see your photos and crop out undesirable background details before you grab the shot.

Whichever you choose, you're not likely to be disappointed. The full-featured megapixel models are more compact than ever and a great bargain (the original Canon Digital ELPH was \$700; for the low-end versions, they're almost a impulse buy, and more than acceptable for everyday use. What they lack in picture quality they make up for in fun.

**CANON
POWERSHOT
S200**

RETAIL PRICE \$350



**BENQ
DC1300**

RETAIL PRICE \$100

**MINOLTA
DIMAGE X**

RETAIL PRICE \$350



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B W k0602



Quandary at The Rental Counter

Should you buy that extra car insurance? Depends

BY PALLAVI GOGOI

You know the feeling. No matter how many times you've rented cars, you still wonder whether you should buy the collision, liability, and theft insurance the rental company offers. The coverage is outrageously expensive—from \$7 to \$25 a day, depending on what you select. Still, one of every five renters takes at least some insurance, according to a recent study by auto insurer Progressive. The most common reason: They don't know if they would be protected otherwise.

If only they had checked with their auto insurer or credit-card company before traveling, they might have saved some money. At least they would have known when it made sense to accept the additional insurance.

Typically, if you have full coverage on your own car—including collision, comprehensive (or theft and fire), and liability for injuries to others—you're covered for the same damages in a rental car. However, consult your insurance agent first, since coverage differs from state to state and conditions may apply.

Consider collision insurance. At the rental counter, you'll pay about \$12 a day for the so-called collision damage waiver that will relieve you of any financial responsibility in case

you're in an accident or return the car with a dent in the door. But what if you have collision protection on your car at home? If your car is worth about the same as a rental car, you can comfortably decline collision damage waiver. If you own an older or less expensive car, be careful: Some companies only protect you up to the value of your own car. So if you drive a 2000 Toyota Camry that's now worth \$15,000 and rent a 2002 model that costs \$25,000, you may not get the difference if the car is a total loss.

To avoid that situation, check your credit cards. Most gold and platinum cards offer collision damages if you use the card to pay for a rental car. They'll pick up the whole tab if you have no other coverage or they'll pay whatever your primary coverage doesn't cover. But there are caveats. Some cards offer this feature as long as the vehicle rental doesn't exceed 15 consecutive days. Many won't cover sport-utility vehicles or very expensive cars such as Rolls-Royce vehicles rented outside the U.S. File your claim more than 20 days after the accident and you may be out of luck. Also note that only credit cards, and private auto policies, for example, will reimburse you for "loss of use" at the daily rate the rental company will charge you for the time it takes to repair the car.

As for liability insurance, rental companies are required by law to provide the state's minimum limits at no extra cost. In Illinois, that would amount to \$20,000 for each person and \$40,000 for the other vehicle. The extra \$7 you agree to in the rental contract could get excess liability coverage of up to \$1 million. But you can't rely on it if you have enough liability insurance through your own auto or umbrella policy.

Two other types of insurance offered to renters are personal accident (about \$3 a day) which provides life and medical insurance for the driver and the passengers in your car, and personal effects (about \$1.25), in case something is stolen from the car. Before signing up, review the coverage from your existing homeowner's, renter's, and health insurance.

Usually, your health or auto policy will pay medical bills resulting from an accident in a rental car. And if you intend to transport extremely valuable items, you don't need personal-effects coverage. "Your homeowner's policy or credit cards will likely cover off-premises theft of personal items from your rental car," says Loretta Worters of the Insurance Information Institute.

Of course, if you don't own a house, or a gold or platinum card, you'd be ill-advised to decline the rental company's coverage. In any case, you're better off paying a few dollars a day than the thousands it would cost if you totaled the car.

Your own car insurance or credit cards may cover most of the extras. But coverage can vary from state to state



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BARGAIN-HUNTING IN THE SMALL-CAP PATCH



BY ROBERT BARKER

rb@businessweek.com

With the recent softening in prices, smaller company stocks may offer good value. Here are five—with strong balance sheets—that stand out

For managers of small-cap stock funds, the big challenge this year had been what to do with all the investor cash coming their way. Unlike large-company stocks, small-cap prices held up pretty well—until June. Suddenly, the bear caught up with shares of small companies. “They’re getting less and less expensive—and maybe even cheap,” says Eric Ende, a veteran small-cap specialist with First Pacific Advisors, who runs FPA’s high-performing yet risk-averse Perennial, Paramount, and Source Capital funds.

As stock prices kept crumbling through late June, Ende stayed busy putting some of that idle cash to work. In search of remaining values as the quarter ended, I began quizzing Ende and other experienced small-cap stockpickers. Here’s a shopping list of five small companies that stand out:

■ **Cognex.** Sales at this 21-year-old maker of “machine vision” gear—cameras that inspect manufacturing lines and guide robots—are off sharply amid the capital-spending crunch. Wall Street expects Cognex to lose money for the full year, but Ende thinks it’s closer to breakeven and sees earnings potential of about \$1 a share. It lost 25¢ a share last year after making \$1.49 in 2000.

Meantime, Cognex has no long-term debt and wields more than \$150 million in working capital.

■ **LogicVision.** Having gone public last November at \$9 a share, LogicVision saw its shares surge above \$15. Now they’re near \$5, and RS Smaller Company Growth Fund manager Bill Wolfenden is buying. The company sells “self-test” circuit designs that semiconductor makers can embed on chips. They use LogicVision’s circuits instead of external test gear to ensure that the microprocessor works correctly. The company owes no long-term debt and holds \$45 million, or \$3 a share, in cash and government securities.

■ **Renal Care Group.** An operator of dialysis centers in 26 states for patients with chronic kidney failure, this company’s sales and earnings have

been growing smartly. Last year, it posted a profit of \$1.52 a share; FPA’s Ende sees \$1.75 this year. As with most any health-care stock, the potential for changes in government reimbursement policy poses a risk. And the stock recently above \$30, Renal Care remained on Ende’s watch list. Where would a buyer? As the stock gets closer to \$25, At that, Renal Care would sell for little more than its rate of profit growth.

■ **Topps.** Shares in this maker of trading cards and candy for kids—it’s responsible for the lipop known as Baby Bottle Pop, a cavity-fighting candy if there ever was one—go in and out of favor. With the fading of the Pokémon craze, Topps contributed candy and stickers, sales

earnings have been shrinking. In the year ended last May, Topps earned 4¢ a share, and the company sees profits sinking to 2¢ this year. It earned 1¢ in its fiscal first quarter. Royce & Associates, an aging director of the stock as a buy or less—and thinks it’s fairly valued at \$13. Topps is debt-free and holds cash of more than \$2.50 a share.

■ **Verity.** Yes, there’s value in an Internet stock. Verity makes software for corporate intranets and Internet portals. Just as you can imagine, those sales have shrunk dramatically down 35% in the year ended May 31. Verity is profitable, having earned 4¢ a share in its fiscal 2002, and the company sees revenue growing 15% to 20% a year ahead. Johnson Family Small Cap Value

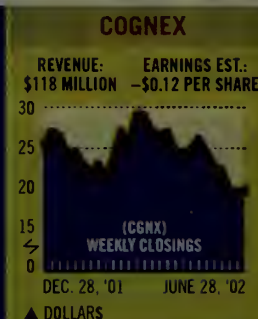
manager Wendell Perkins owns the stock part because he likes the company’s balance sheet, which shows more than \$4 a share in cash but no debt. Perkins also favors Verity’s market share, making it the leader in a fragmented industry.

Will all of these companies prosper? I don’t say. But if you have cash to put to work in stocks, identifying financially strong companies like these and waiting for the sellers to offer a good price is a solid first step.

The Pros' Picks

REVENUE IS FOR MOST RECENT 12 MONTHS. EARNINGS ESTIMATES ARE FOR CURRENT FISCAL YEAR

Data: Standard & Poor's BusinessWeek



BusinessWeek online

For barker.online, go to www.businessweek.com/investor/ and click on “Col

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As the market continues to drag lower, investment pro Roger Lipton is steadfastly buying more shares—mostly of battered “value consumer stocks” that he thinks are poised to snap back. Lipton is no wild-eyed optimist: His hedge fund, RHL Associates, is up 43% in the past 12 months and ahead 22% this year. Surprisingly, he has been mostly long on stocks. Of late he has been buying more of OfficeMax (OMX), the third-largest office products retailer, with some 1,000 superstores in 49 states. He’s also high on Tweeter Home Entertainment (TWTR), a Canton (Mass.)-based retailer of high-end audio and video consumer electronics with stores in New England, the mid-Atlantic, and the Southeast. OfficeMax has fallen to 6 a share from 8 in early May. It traded as low as 1.20 a year ago. Tweeter is down to 15 from 30 in January. OfficeMax has posted losses in the past two years. And Tweeter has cut the number of stores it plans to open next year.

Lipton sees OfficeMax turning profitable in 2002, earning 15¢ to 20¢ a share, and then 40¢ to 50¢ in 2003. Rivals Staples and Office Depot are twice as big, “but service at OfficeMax is better, with comparable products,” he says. A new marketing system will enable it to compete better with bigger rivals—and grow rapidly, he adds.

Tweeter, which earned 84¢ on sales of \$540 million in fiscal 2001 ended Sept. 30, should earn 90¢ on sales of \$675 million in 2002 and \$1.10 on \$843 million in sales in 2003, says Lipton. He sees Tweeter at 25 in 12 months.

LIPTON'S VALUE BETS

STOCK	PRICE ON JULY 2	52-WEEK HIGH-LOW	12-MOS. TARGET
OFFICEMAX	\$5.27	\$8.06-2.50	12
TWEETER	13.45	\$37.68-12.02	25

Data: Bloomberg Financial Markets, RHL Associates

ERICSSON HAS SOME LONELY FANS

Most everybody has just about given up on Sweden's Ericsson (ERICY), the world's largest maker of wireless networks. Its shares have plunged from 6.20 a share on Dec. 5 to 1.55 on July 2. With the weak market for wireless handsets, and its major telecom customers heavily in debt and delaying orders for new mobile systems, Ericsson remains awash in red ink as revenues keep falling. Is it headed toward insolvency, as some analysts suggest?

Far from it, says Per Lindberg, analyst at Dresdner Kleinworth Wasserstein in London, who doesn't own shares, rates Ericsson a buy. He attributes most of Ericsson's woes to a cyclical downturn. Sure, its market share in the handset business

has eroded, but he sees a strong upturn in orders in the second half driven by handsets with such new features as color video and a camera. Lindberg doesn't see the “liquidity issue” that the bears suggest. It “has defied extremely difficult demand conditions,” he says, “by swift cost-cuts” and by focusing on efforts to “self-finance operations.”

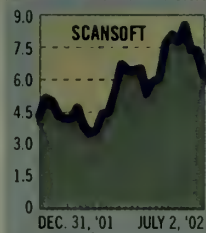
Vince Carino of Brookhaven Capital Management, which has been buying shares, says Ericsson's balance sheet is stronger than the Street perceives: It has \$6 billion in cash, vs. debt of \$8.5 billion, leaving net debt of \$2.5 billion. That doesn't worry him, since Ericsson is selling some noncore assets. Ericsson, he adds, had positive cash flow in the past four quarters and currently has \$2 billion in free cash flow. He sees 2002 a wash on sales of \$18 billion. The company should make 15¢ a share on sales of \$22 billion in 2003, and 25¢ in 2004 on \$25 billion sales—prior to any major asset sales, forecasts Carino.

One big positive: It's likely that Ericsson will sell its 50% stake in the Sony-Ericsson joint venture on wireless handsets to Sony, says Carino. He puts the stake's value at \$4 billion, or 50¢ a share. “The market has yet to appreciate the stock's huge upside potential, and Ericsson's progress in improving operations,” says Carino.

HARD LANDING AHEAD FOR SCANSOFT?

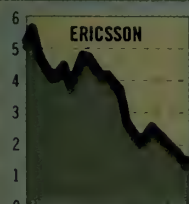
ScanSoft (SSFT), a major supplier of digital imaging, speech, and language solutions—such as voice-related technologies for telecoms—to make businesses more productive, has been flying high. It reached 6.05 a share on July 2, up from 3 in early March—with a lofty price-earnings ratio of 30 on 2001's earnings of 19¢ a share, or 23 times estimated 2002 earnings of 26¢. Enter the shorts. Selling at about five times revenues, they think the stock is too pricey. And there is the link to Xerox, which owns a 20% stake. Xerox, under a Securities & Exchange Commission accounting probe, is also a major ScanSoft customer contributing 14% to revenues. Xerox is restating up to \$6 billion in revenues from 1997 to 2001. “Given the investor sensitivity to accounting, the restatement could cast a negative shadow on ScanSoft,” says one pro, who sees the stock falling to 4. A bull on ScanSoft is Katherine Egbert, of C.E. Unterberg, who rates the stock a buy, with a 12-month target of 12. She sees 2002 earnings of 26¢ a share and 35¢ in 2003. Say the shorts: Her valuation is too steep.

IN THE SHADOW OF XEROX



Data: Bloomberg Financial Markets

JUST A CYCLICAL DOWNTURN?



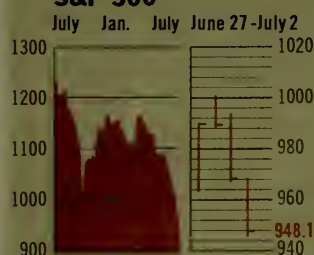
▲ DOLLARS
Data: Bloomberg Financial Markets

BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:40 p.m. EST on CNNfn's *The Money Gang*.

Stocks

S&P 500



COMMENTARY

The stock market suffered another drubbing in the wake of WorldCom and other corporate accounting scandals. Persistent investor discontent, analyst downgrades, and worries about terrorist threats over the July 4 holidays didn't help. The S&P 500 and the Nasdaq Composite fell to levels not seen since 1998. For the week, the Dow lost 1.2%, the S&P 2.6%, and Nasdaq 5%.

Data: Bloomberg Financial Markets
Reuters

U.S. MARKETS

	July 2	Week	Year to date	Last 12 months
S&P 500	948.1	-2.6	-17.4	-23.3
Dow Jones Industrials	9007.8	-1.2	-10.1	-15.0
Nasdaq Composite	1357.8	-5.0	-30.4	-36.8
S&P MidCap 400	463.7	-3.3	-8.8	-10.2
S&P SmallCap 600	218.3	-3.4	-6.0	-4.4
Wilshire 5000	8961.6	-2.8	-16.3	-21.9

SECTORS

	July 2	Week	Year to date	Last 12 months
BusinessWeek 50*	590.7	-3.3	-19.1	-31.4
BusinessWeek Info Tech 100**	288.2	-1.7	-31.3	-38.8
S&P/BARRA Growth	470.6	-3.8	-20.9	-23.8
S&P/BARRA Value	474.4	-1.4	-14.1	-23.5
S&P Energy	212.6	0.1	0.6	-7.6
S&P Financials	326.1	-0.3	-8.2	-15.8
S&P REIT	100.4	-1.2	7.5	6.3
S&P Transportation	194.4	2.2	-1.3	-4.2
S&P Utilities	117.8	-2.0	-19.2	-37.0
GSTI Internet	64.3	-8.8	-38.8	-53.6
PSE Technology	469.7	-6.3	-31.7	-35.6

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Railroads	6.1	69.1
Footwear	2.4	36.4
Specialty Chemicals	0.7	35.1
Homebuilding	0.1	33.5
Oil & Gas Refining	0.0	29.2

EQUITY FUND CATEGORIES

4-week total return	%	52-week total return	%
Leaders			
Real Estate	1.4	Precious Metals	67.4
Europe	-2.8	Real Estate	13.9
International Hybrid	-3.6	Pacific/Asia ex-Japan	5.5
Natural Resources	-3.6	Small-cap Value	3.2
Laggards			
Communications	-15.4	Communications	-48.7
Technology	-14.3	Technology	-46.2
Latin America	-14.2	Health	-28.2
Precious Metals	-12.5	Large-cap Growth	-26.5

EQUITY FUNDS

4-week total return	%	52-week total return	%
Leaders			
Rydex Dynamic Vent. 100	30.4	Rydex Dynamic Vent. 100	111.3
ProFunds UltraShort OTC	30.1	ProFunds UltraShort OTC	106.1
Potomac OTC Short	15.1	First Eagle SoGen Gold	102.4
Rydex Arktos Investor	14.9	U.S. Glob. Wld. Prec. Minls.	99.8
Laggards			
American Heritage	-27.3	ProFunds UltraOTC Inv.	-76.5
ProFunds UltraOTC Inv.	-27.3	Black Oak Emerging Tech.	-71.8
American Heritage Growth	-25.0	Van Wagoner Post Venture	-69.8
iShares Gold. Sachs Netwkg.	-24.9	Van Wagoner Technology	-68.3

Data: Standard & Poor's

GLOBAL MARKETS

	July 2	Week
S&P Euro Plus (U.S. Dollar)	981.5	1.3
London (FT-SE 100)	4546.8	0.3
Paris (CAC 40)	3735.7	0.9
Frankfurt (DAX)	4196.0	2.4
Tokyo (NIKKEI 225)	10,622.3	5.4
Hong Kong (Hang Seng)	10,491.8	1.3
Toronto (TSE 300)	7013.4	-0.1
Mexico City (IPC)	6306.5	2.2

FUNDAMENTALS

	July 1	Week
S&P 500 Dividend Yield	1.64%	
S&P 500 P/E Ratio (Trailing 12 mos.)	41.2	
S&P 500 P/E Ratio (Next 12 mos.)*	16.8	
First Call Earnings Surprise*	6.47%	

*First Call Corp.

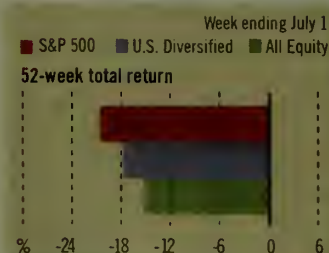
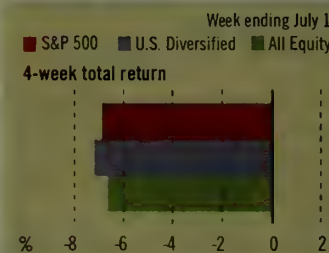
TECHNICAL INDICATORS

	July 1	Week
S&P 500 200-day average	1099.9	1100
Stocks above 200-day average	56.0%	
Options: Put/call ratio	0.82	
Insiders: Vickers NYSE Sell/buy ratio	3.86	

WORST-PERFORMING GROUPS

	Last month %	Last 12 months %
Wireless Services	-44.6	Multi-Utilities
Advertising	-40.9	Wireless Services
IT Consulting	-35.6	Computer Stge.
Semiconductors	-34.1	Application Sof.
Broadcasting & Cable TV	-33.0	Telecomms. Equ.

Mutual Funds



Data: Standard & Poor's

Interest Rates

KEY RATES

	July 2	Week
MONEY MARKET FUNDS		
90-DAY TREASURY BILLS	1.48%	1.4
2-YEAR TREASURY NOTES	2.76	2.75
10-YEAR TREASURY NOTES	4.73	4.7
30-YEAR TREASURY BONDS	5.44	5.43
30-YEAR FIXED MORTGAGE†	6.54	6.54

†BancQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENT

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 30% federal tax rate.

	10-yr. bond
GENERAL OBLIGATIONS	4.10%
TAXABLE EQUIVALENT	5.86
INSURED REVENUE BONDS	4.28
TAXABLE EQUIVALENT	6.11

THE WEEK AHEAD

INSTALLMENT CREDIT Monday, July 8, 3 p.m. EDT ► Consumers are forecast to have piled up \$5.6 billion of new debt in May. That's according to the median forecast of economists surveyed by Standard & Poor's MMS, a division of The McGraw-Hill Companies. In April, consumer debt rose by \$8.9 billion. In the first quarter, installment credit rose \$18.9 billion. Revolving debt, made up mostly of credit cards, jumped by \$4.1 billion in April, after remaining flat from November to March.

EXPORT-IMPORT PRICES Wednesday, July 10, 8:30 a.m. EDT ► Import prices in June probably rose 0.2%, after remaining unchanged in May. June export prices most likely stayed unchanged, after a 0.1% fall in May. A steadily falling dollar could benefit American businesses, causing U.S. goods and services to become comparatively cheaper abroad.

PRODUCER PRICE INDEX Thursday, July 11, 8:30 a.m. EDT ► Producer prices of finished goods in June most likely rose by a

slight 0.1%, following a fall of 0.1% through May. Excluding food and energy, core prices probably increased 0.1% last month, after remaining unchanged during May.

RETAIL SALES Friday, July 12, 8:30 a.m. EDT ► Retail sales in June are forecast to have risen 0.7%, after weak performance contributed to an unexpectedly decline of 0.9% in May. Excluding autos, sales probably increased 0.5%, after a 0.4% drop in

BusinessWeek Fifty

Jan. July

Weekly

Daily: June 27-July 2

650
630
610
590.7
570

3.3% for the week ending July 2, with 80% of the companies declining. Leading the losers was Systems, which fell 30.6% over fears concerning its exposure to WorldCom, one of its Drug distributor Cardinal Health sank 11.7% after rumors of auditing problems at the com-vestors. The bright spot? Tyco International, which rose 5.7% after the spinoff of its CIT unit.

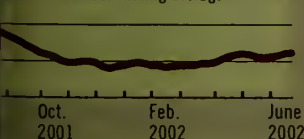
COMPANY PERFORMANCE

Company	% change		Rank	Company	% change	
	Week	Since 3/1/02			Week	Since 3/1/02
Johnson	-4.7	-15.3	26	Tenet Healthcare	-2.7	21.0
c	-0.4	-5.6	27	Household International	-2.2	-7.6
	-6.3	-19.9	28	WellPoint Health Networks	-5.5	23.1
	1.4	-6.8	29	Washington Mutual	-2.5	12.8
s	1.6	-13.2	30	Duke Energy	-4.1	-15.0
	-7.8	-30.6	31	Kohl's	-2.2	0.9
	-0.3	-7.0	32	Bed Bath & Beyond	-3.6	6.6
	-1.4	-3.2	33	Cardinal Health	-11.7	-17.7
	-4.4	-23.8	34	Centex	-2.5	-6.7
eBergen	-8.0	4.1	35	American Electric Power	-3.9	-12.2
h Group	-0.8	24.5	36	Golden West Financial	0.9	6.5
	-1.8	2.9	37	Stryker	-6.2	-19.9
t	-7.6	-32.5	38	Harley-Davidson	-3.0	-5.3
ores	-4.0	-13.9	39	PepsiCo	-3.0	-5.4
	0.0	-75.6	40	Merck	-6.8	-23.5
amics	-1.1	12.1	41	Apache	-0.8	7.4
roleum	0.3	-2.7	42	Amerada Hess	1.3	16.0
ratories	-2.0	-13.2	43	KB Home	-3.5	14.2
)	1.2	-9.7	44	First Data	-3.6	-11.9
	5.3	-16.3	45	Tyco International	5.7	-56.5
Petroleum	-2.7	8.3	46	International Game Technology	-2.3	-20.4
	-1.8	-12.0	47	Capital One Financial	-0.1	15.2
s	-4.5	5.8	48	Electronic Data Systems	-30.6	-49.0
il	-1.0	-5.1	49	Nabors Industries	-3.8	-2.2
	1.3	-17.2	50	Xcel Energy	2.5	-32.5

Production Index

Change from last week: 0.2%
Change from last year: -3.6%

L OUTPUT June 22=162.3 1992=100
Index is a 4-week moving average



index was higher for the week. Before the four-week moving average, however, to 162.3 from 162.6. After seasonal adjustment and steel production were higher. Assemblies both increased, following of a parts-supplier strike that forced plants to close. The energy components of refining, and electric power were all h rail-freight traffic.

of the index components is at www.businessweek.com.
Production Index Copyright 2002 by The McGraw-Hill

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BusinessWeek online

For more investment data and the components of the production index, visit www.businessweek.com.

Welcome BACK

THE ALEUTIAN

Canada goose, one of more than a dozen subspecies of Canada geese, is back from a brush with extinction. In the 1960s, there were only a few hundred of these graceful migratory birds left. Today they number more than 30,000, thanks in large part to conservation efforts by Ducks Unlimited and others. That's a job well done, but more work remains. Hundreds of other wildlife species are in decline, victims of habitat loss, pollution, and competition with introduced species. They need your help.



DUCKS UNLIMITED

Call 800-45-DUCKS or visit DU's Web site at www.ducks.org.

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This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names. Companies listed only in tables are not included.

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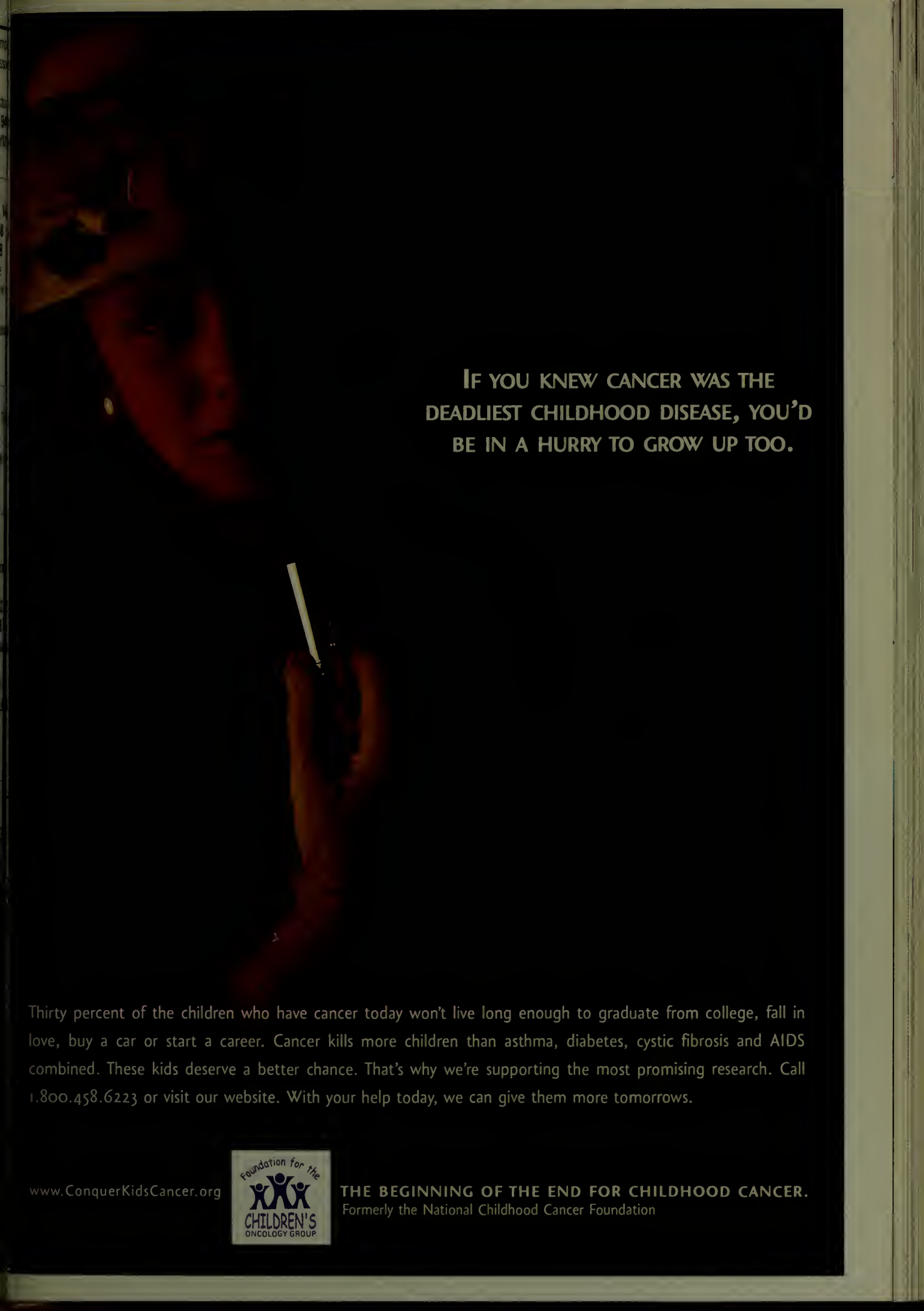
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THE SYSTEM NEEDS FIXING, MR. PRESIDENT

Dear President Bush: This Fourth of July finds the nation at a tipping point. Americans are starting to bail out of the equity culture that made this nation so prosperous and powerful over the past two decades. Many no longer trust Corporate America. They're putting their new cash into banks, bonds, and building bigger houses. And some are beginning to dump all their previous investments in stocks and mutual funds.

This is a crucial moment, Mr. President. America's real power in the world is based not merely on military might but also on its successful model of market-driven economic growth and prosperity. However, many foreigners are now saying the '90s were a sham and the model is a fake. They are about to join jittery U.S. investors in dumping USA Inc. That is what the sinking dollar is really all about.

Up to now, Mr. President, you've focused on the rotten apples. To your credit, you have publicly condemned CEOs who have broken the legal and ethical codes of our society. There are now criminal charges against the ex-CEO of Tyco International Ltd., L. Dennis Kozlowski and the CEO of Imclone Systems Inc., Sam Waksal. The bunch at Enron Corp. and WorldCom Inc. will probably be indicted as well. But the problem goes much deeper, Mr. President. Corrupt practices have seeped into rock-solid companies. The model of a high-risk, high-growth economy based on honest financial numbers and arm's-length transactions has broken down and needs repair. It may be hard for you as a believer in deregulated markets to admit, but there are major defects in accounting, corporate governance, and Wall Street behavior. It goes way beyond rotten apples, Mr. President. The barrel has a few busted planks, too.

OPPORTUNITY KNOCKS

Mr. President, you've got a speech on corporate crime coming up on July 9 (page 32). Your political advisers are saying you have to show anxious voters you care about them as the November congressional elections approach. Mr. President, you've got to do a lot more. You've got to convince Americans at home and people abroad that this nation is cleaning its corporate house. You've got to help restore the trust that millions of small investors will need before they risk putting their money into equities again. If you don't, Americans will retreat to safety, and flows of overseas capital will dry up. Stocks will stagnate, economic growth will slow, the budget deficit will soar, the dollar will tank, and America's prestige and power on the world scene will erode. Mr. President, your speech should be not about comforting voters but about preserving our dynamic economic system.

There are some radical steps being proposed to restore public confidence that deserve your attention. One is to have all publicly listed corporations contribute to a fund that pays for accounting firms to audit their books. That would effectively end the fundamental conflict of interest accountants now

face when they must police the very companies that pay their fees. Another radical proposal is to separate the chief executive and chairman of the board. The chairman would represent shareholder interests while the chief executive manages the company.

A TOOL KIT FOR THE ECONOMY

Both ideas have merit. But Mr. President, if they go for you, there are other proposals you could back:

■ **Support tough accounting reform.** Your Administration to send a powerful signal by punishing Arthur Andersen's death, but the accounting profession isn't getting the message. The Final Four are fighting meaningful reform in Congress. Mr. President, when self-regulation doesn't work and the financial system is threatened, you have to change the rules of the game. Tell Americans you are throwing your weight behind the tough accounting reform bill being proposed by Senator Paul S. Sarbanes (D-Md.). This legislation would create a new oversight board that is run by a full-time board which would set higher standards and punish those who don't meet them. Announce that the board will insist that firms rotate their auditors every five years. Finally, tell the country that you are going to support the Volcker plan for split auditing from consulting to avoid conflicts of interest and explain how smart CEOs are already doing this.

■ **Make CEOs responsible.** We need a clean slate in financial reporting, a new benchmark for the bottom line that investors can believe in. Tell the audience you are supporting the SEC's proposal to get the CEOs of the 1,000 biggest corporations to sign off on their companies' financial statements personally. And say you are accepting Treasury Secretary Paul O'Neill's idea of making CEOs legally liable for those statements. Tell the people you are asking government enforcers to take back CEOs' ill-gotten gains from stock options based on phony numbers.

■ **Back Wall Street reform.** Throw the weight of your administration behind the New York Stock Exchange's proposals to clean up corporate governance by replacing insiders on board committees with independent members, especially on key committees and compensation committees. Publicly support the Lynch & Co.'s agreement with New York State Attorney General Eliot Spitzer that stops analysts from owning and trading stocks they cover or paid for bringing in investment banking business. Say it should be a model for all of Wall Street.

Mr. President, we realize giving a speech that endorses these proposals would be no small task. But our free-market system depends on the flow of credible information: independent and reliable reports prepared by honest CEOs and independent boards; certified by accountants who adhere to the highest professional standards; and studied by Wall Street analysts free of conflicts of interest. Is that too much to ask?

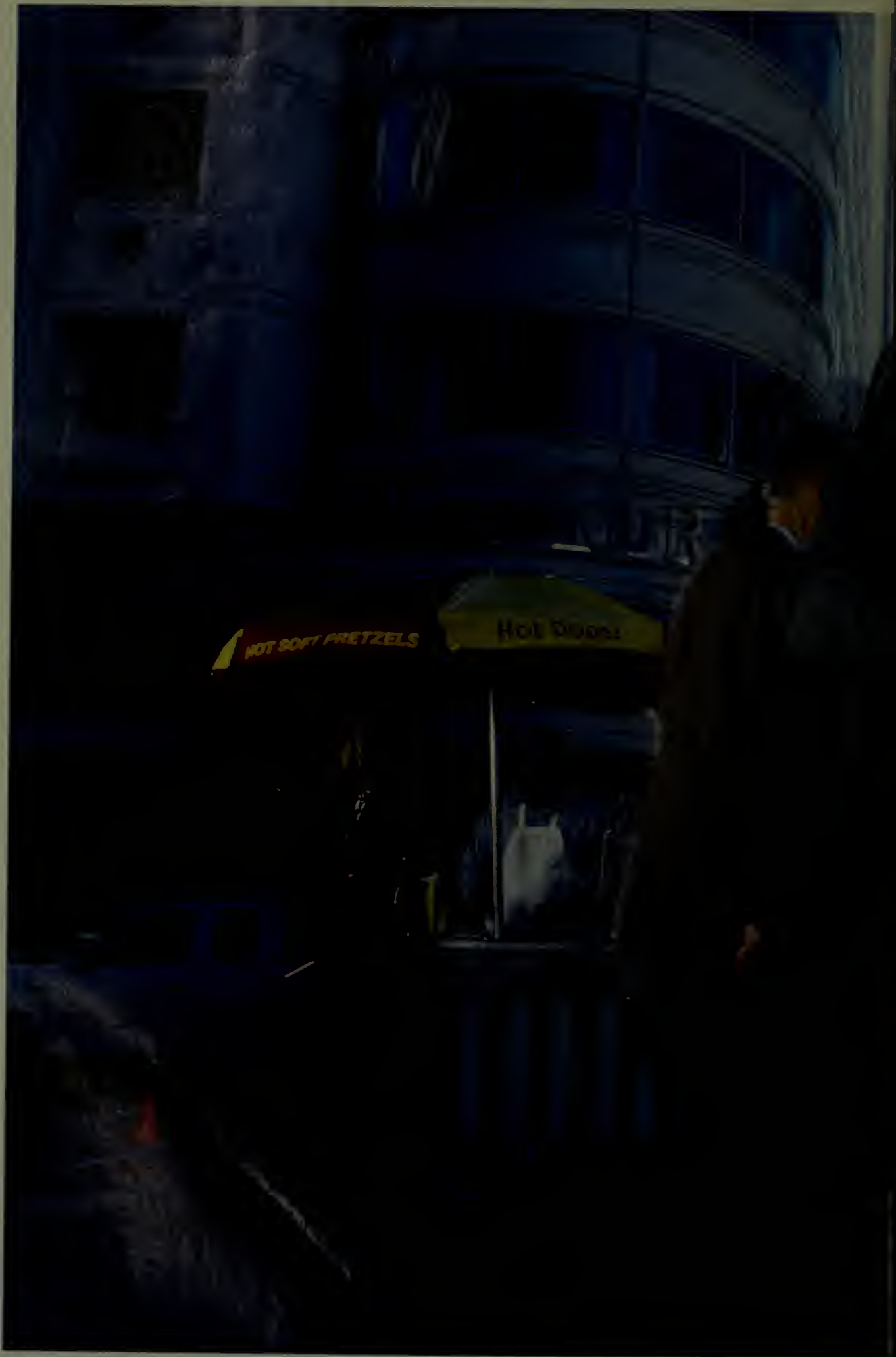
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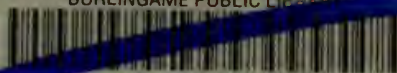


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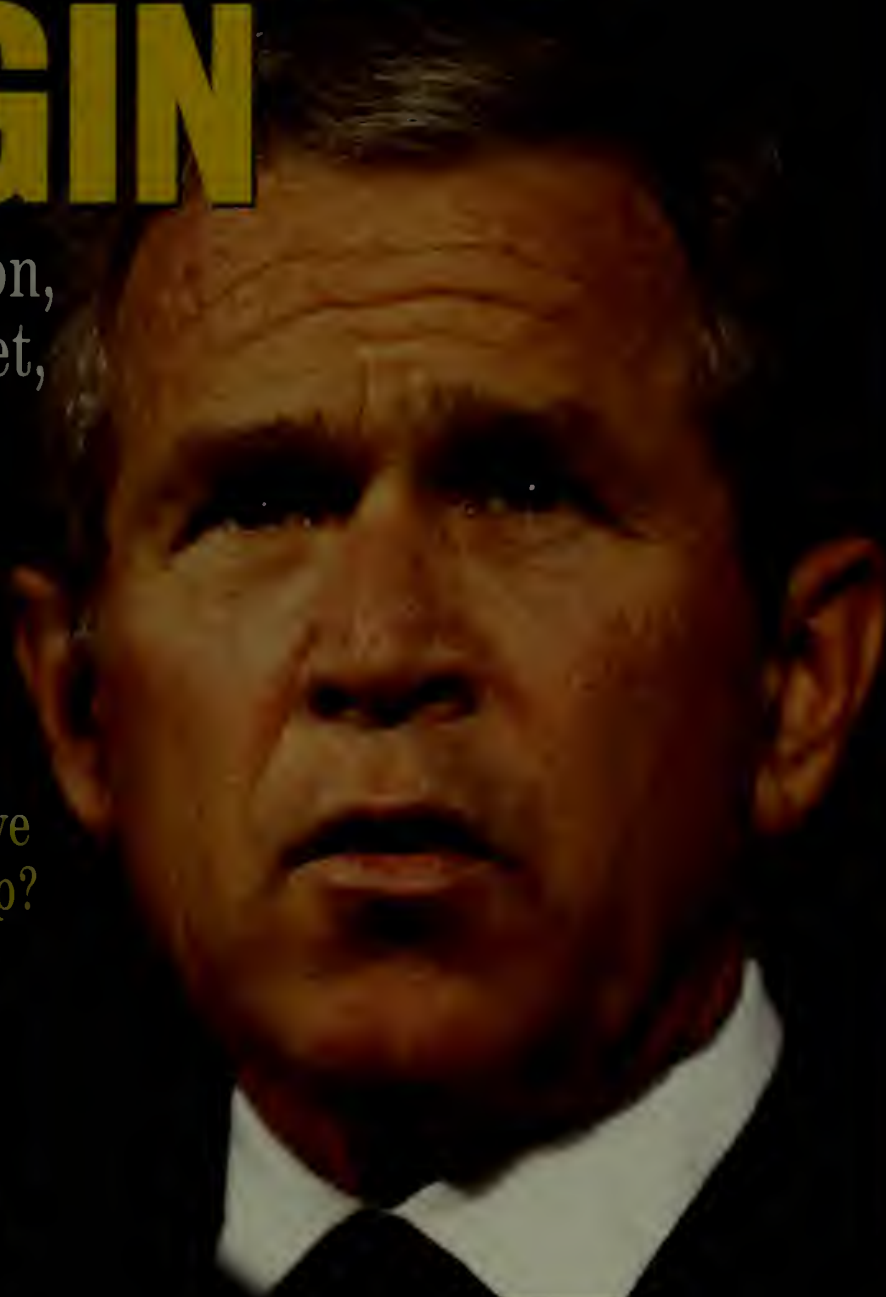
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LET THE REFORMS BEGIN

In Washington,
on Wall Street,
in Corporate
America:

It's time to
just do it!

PLUS Do Bush
and Cheney have
a credibility gap?



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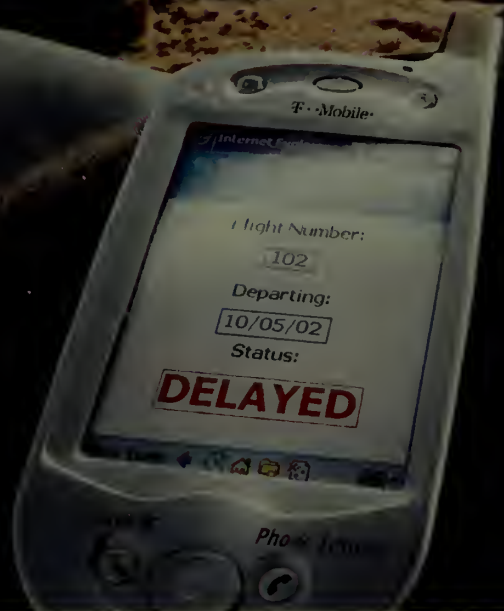
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COVER STORY

LET THE REFORMS BEGIN

In Washington, on Wall Street,
and in Corporate America:
It's time to just do it!

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BusinessWeek

JULY 22, 2002

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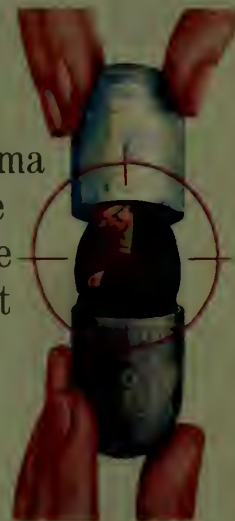
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Beware the tax consequences of early withdrawals, says BW's Peter Coy



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Check on the health of your investments



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Use more than 70 criteria to pan for gold among the equities



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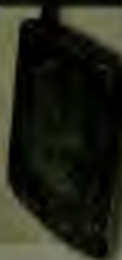


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An Open Letter

Views & Comments for 01/2000-1999
negotiated Joe. Stan Fischer is well known to be a person of unimpeachable integrity. Of all the false inferences and innuendos in this book, this is the most outrageous. I'd suggest you should pull this book off the shelves until this slander is corrected.

DISMAL SCIENTISTS

THE IMF GETS DOWN AND DIRTY

A CLASH BETWEEN GLOBAL economists is getting ugly. For years, the International Monetary Fund has listened to former World Bank chief economist and Nobel laureate Joseph Stiglitz blast its policies in emerging markets.

Now, it's taking the gloves off and landing its own blows. At a June 28 panel in Washington to discuss Stiglitz' new book, *Globalization and Its Discontents*, a senior IMF official stunned Stiglitz with a caustic counterattack. Calling Stiglitz' own economic prescriptions "at best highly con-

troversial, at worst snake oil," IMF Research Director Kenneth Rogoff asserted Stiglitz made the 1997 Asia crisis worse by publicly challenging IMF policies. Rogoff called slanderous

and "outrageous" Stiglitz' remark in the book that former IMF Deputy Managing Director Stanley Fischer may have landed a plum job at Citigroup as a reward for his handling of debt negotiations.

The IMF posted the attack on its Web site, along with another tongue-lashing by External Relations Director Thomas Dawson. Both are being widely circulated via e-mail.

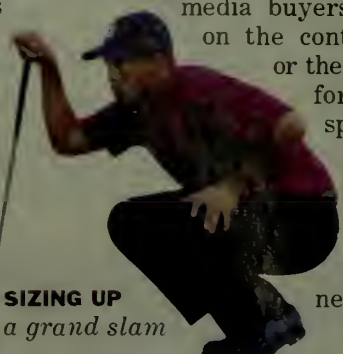
Stiglitz says he feels ambushed, that he didn't affect the Asia crisis, and that his comments are fair. "It's clear they are trying to get personal and vindictive against me," he says. The IMF says that it has no further comment. *Pete Engardio*

TV TACTICS

SELLING TIGER ANY WAY THEY CAN

THE BRITISH OPEN, BEGINNING on July 18, is almost guaranteed to be a TV-ratings smash, thanks to Tiger Woods's pursuit of golf's Grand Slam. "I suspect this will become the biggest story in American sports this summer," says former CBS Sports President Neal Pilson.

Too bad ABC, which is televising it, can't take full advantage and jack up ad rates. Most of the network's ad time was sold months



SIZING UP
a grand slam

ago at prices lower than it could get now that Woods has gone two-for-two at the Masters and the U.S. Open.

But ABC has found a way to leverage Tigermania. For advertisers seeking what little British Open ad time is left, it's giving priority to those who also buy time on a made-for-TV golf exhibition, the *Battle at Bighorn*, starring Woods on July 29. Some media buyers aren't keen on the contrived format or the \$150,000 price for a 30-second spot on a show that critics panned last year. Still, three weeks in advance, it's nearly sold out.

Mark Hyman

TALK SHOW "Capitalism needs to check itself into the Betty Ford Center for a bit of sobering up, and I think investors need to do the same thing." —Paul McCulley, PIMCO managing director, on CNBC's Morning Call

HWAY PATROL

CHALK ONE UP FOR FREE WIRELESS

PICTURE HOODED TWENTY-somethings scanning city blocks for hot spots and clandestinely chalking symbols on sidewalks and buildings. Modern revolutionaries? Kind of. They're "warchalkers," letting wireless laptop users know



where they can find free connections to the Internet using Wi-Fi (wireless) technology. Two half-moons scrawled on a wall, for example, means there's access within 1,000 feet.

The symbols are the cre-

ation of Londoner Jones, who posted along with a photo of in the act, on his Web on June 24. "Warchalk minded me of when I Boy Scout and we laid in a configuration on to direct people to the friend, Ben Hamr explains. It quickly across the Net. Wi week, Jones's site wa link on popula site Slashdot.or he was getting from Baltimore tle, Copenhagen Utah, with pho dence of imitate

Critics scoff particularly in cities like S chalk won't las those who disco terlopers can cl their networks some Internet providers, inc Time Warner and AT&T, are tr

crack down on user share their connection the unpaid masses.

Despite such hurdles may well be enough committed to Wi-Fi s that more warchalking will enlist. *Jane*

THE LIST ROAD RAGE CANDIDATES



Ugh, highway traffic. Here are the six most congested are

METRO AREA	TIME WASTED PER COMMUTER*	FUEL WASTED PER COMMUTER*	PERCENTAG FREEWAY CON DURING RUSH
LOS ANGELES	136 hours	204 gallons	85°
SAN FRANCISCO-OAKLAND	92	149	75
WASHINGTON	84	136	70
SEATTLE-EVERETT	82	137	75
HOUSTON	75	123	60
DALLAS-FORT WORTH	74	120	50

*Annual, 2000 data

Data: Texas Transportation



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of business.

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Up Front

ACTIVIST ACTION

A BITTER HARVEST BY FAST-FOOD CHAINS?

WATCH FOR A FOOD FIGHT between fast-food chains and shareholders over charges of using lettuce and tomatoes picked by underpaid workers.



SUPPORTING FARM HANDS at Taco Bell HQ

The shareholders are drafting resolutions to force suppliers to pay higher wages and improve working conditions. "Burger King is first," says Ruth Rosenbaum, a Roman Catholic nun leading the charge, along with Trillium Asset Management and the United Church of Christ (which have a combined \$3.6 billion under management). Rosenbaum cites Burger King as one of the largest buyers of produce picked by poorly paid workers. "Issues like this are not going away," she says. A spokesman for Burger King says its suppliers are required to adhere to labor

laws and pay minimum wage.

The campaign follows a similar one last fall against Taco Bell's parent, Yum! Brands, formerly Tricon. For the past year, activists have protested against Taco Bell for buying tomatoes picked in Immokalee, Fla. Workers endure rough treatment and are paid as little as 40¢ per 32-pound tomato bucket, says Student-Farmworker Alliance activist Julia Perkins. That's below the minimum wage, the group says. At least six companies employ Immokalee pickers.

The largest, Six L's Packing, declined comment.

Three universities have banned Taco Bell products over the tomato issue. But Yum says it's not responsible for its suppliers' actions—a claim once made by Nike and other apparel makers in the '90s before being forced to be more accountable by consumer boycotts. "We are not now or ever going to get involved in a labor dispute between third parties," says Yum exec Jonathan Blum.

Yet until pickers' wages improve, worker advocates advise, hold the pickle, hold the lettuce. *Brian Grow*

DRAWN & QUARTERED



E-TAIL HOOKS

ONLINE SAVINGS ARE IN BLOOM

E-TAILERS HAVE LONG BATTLED the problem of online buyers suddenly turning skittish and abandoning their purchases before clicking through to checkout. Jupiter Media Metrix says that two-thirds of Web shoppers do it.

So a segment of e-tailers has a solution. Online florists, including FlowersUSA.com and JustFlowers.com, entice customers who try to leave before completing purchases with a pop-up discount window. It offers an average of \$5 off if they complete their orders immediately. 1-800-Flowers.com recently tested pop-ups and is evaluating the results.

It started two years ago at Flowers USA when CEO Dave Adams noticed 4,000 started-but-not-completed

Mother's Day orders. ers USA now keep more customers, and credits pop-ups with \$660,000 to last year

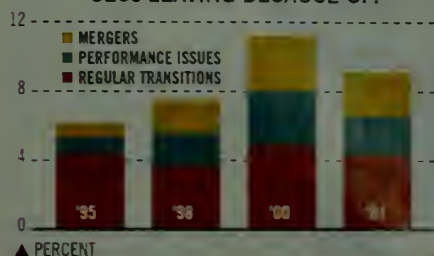
mill sale S othe have copied move. "This is really clever. I'm not expecting an Amazon or eBay it," says Ken Cassar, an analyst at Jupiter. Most profit margins are too to offer last-minute deals. They're already counting as much as can. *Ann Therese P*

THE BIG PICTURE

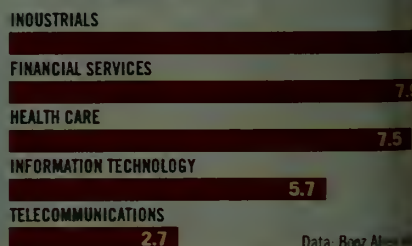
REVOLVING-DOOR CEOs

Job insecurity isn't just a problem for the rank and file. CEO turnover is down from its 2000 peak, but because of mergers and poor job performance, it is 50% higher than it was in 1995. CEOs at industrial companies last the longest. Those at telecom companies have the shortest tenure.

CEOs LEAVING BECAUSE OF:



AVERAGE YEARS OF CEO TENURE IN



Data: Booz Allen

Polls, surveys, and other items for this section

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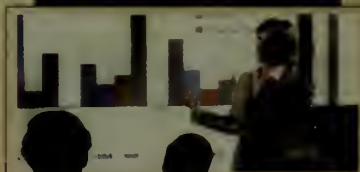
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Readers Report

CHEERS, NOT JEERS, FOR THE SEC'S REGULATORY EFFORT

The quote attributed to me in "The SEC can't guard the house alone" (Special Report, July 1)—on the Securities & Exchange Commission's proposal for a Public Accountability Board to regulate accounting—although accurate, makes it appear that I am critical of the proposal. In fact, I support the proposal in its essential features. The SEC's proposal [would have] regulatory action in place before the next audit season.

In light of the constant revelations of improper financial reporting that have sapped investor confidence, there is no doubt that strong action by the SEC to use its existing authority to restore that confidence is to be applauded.

Stanley Keller
Boston

Editor's note: The writer is a partner in the law firm Palmer & Dodge LLP and is chair of the American Bar Assn.'s Committee on Federal Regulation of Securities.

AN AIRLINE'S 'MODEST REQUEST' FOR LONG BEACH

"American draws a bead on JetBlue" (News: Analysis & Commentary, June 24) states that American Airlines Inc. is "pushing Long Beach [Calif.] authorities to revoke some of JetBlue's unused landing rights and award them to American." In fact, American has no objection to Long Beach allowing JetBlue to proceed as it agreed, so long as other carriers are allowed to introduce new service as well. The city's 41-slot cap is a local limit that Long Beach can amend at any time. American has made a modest request for only four additional permanent slots, and we have told the city it can meet its obligations under federal law

by making the slots available to within Long Beach's 41-slot limit increasing that limit. We are not "nining" for anyone. Our only interest operating two new routes.

Timothy J. Doke, Vice-President
Corporate Communications
American Airlines

A WAKE-UP CALL ON A SLEEPY TOPIC

Re "What to bet against" (Business Week Investor, July 1, some e Cephalon Inc. has stated repeated investor conferences and in meetings] that it is completing clinical studies designed to demonstrate the potential effectiveness of a drug to treat excessive sleepiness associated with a number of medical disorders. The drug is currently cleared for marketing in the U.S. to treat only excessive time sleepiness associated with narcolepsy. Cephalon is not seeking approval for Provigil to treat depression.

Robert W. Grupp, Vice-President
Corporate Communications
Cephalon
West Chester, Ohio

TWO LESSONS FROM THE ARTHUR ANDERSEN SAGA

"The lingering lessons of And fall" (Special Report, July 1). "The government's decision to take the jugular was overkill, but it will have far-reaching beneficial effects. I strongly disagree. Uncovering fraud is never an easy task. As a result of prosecution, the accounting profession will suffer from not being able to attract the best and brightest business school graduates. The prospect does bode well for accounting and its

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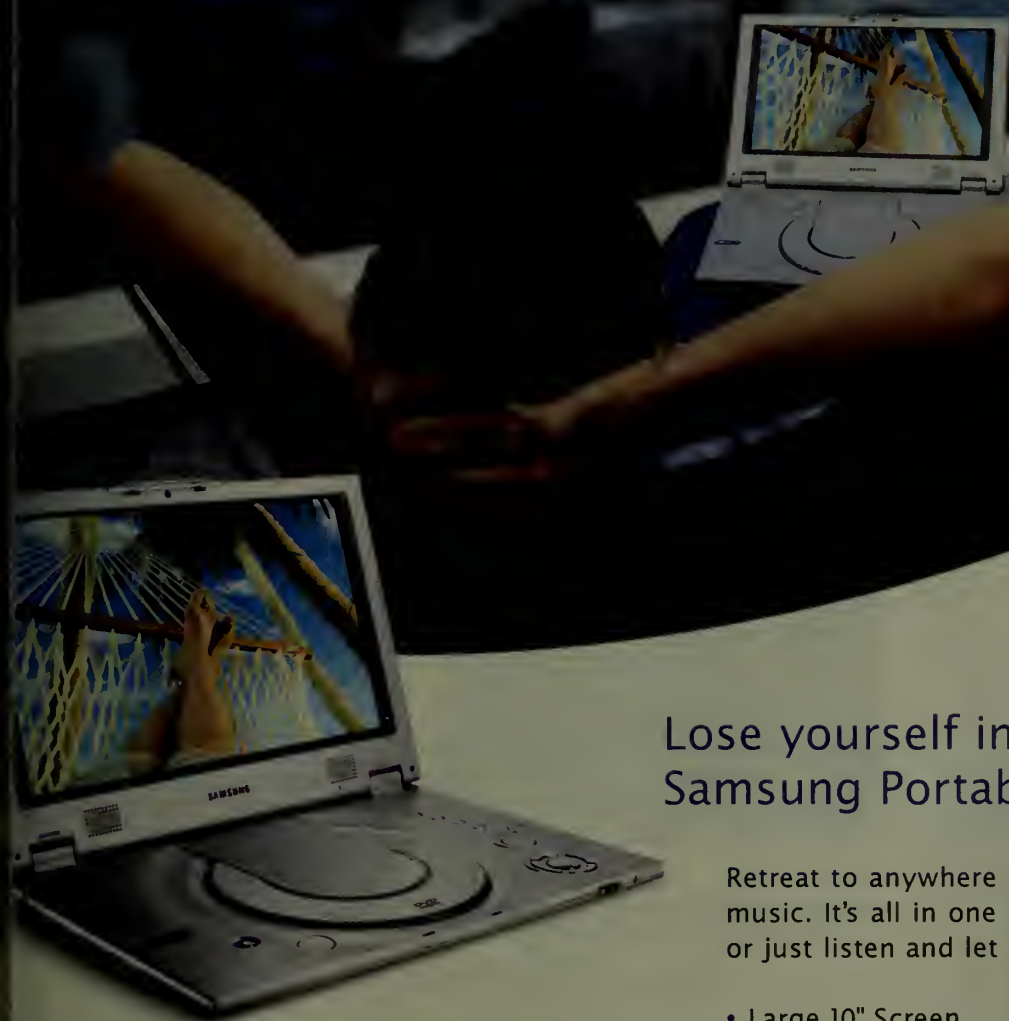
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Readers Report

CORRECTIONS & CLARIFICATIONS



In "WorldCom's sorry legacy" (Special Report, July 8), the photo that purported to show Scott D. Sullivan, former CFO of WorldCom Inc., was not Sullivan. The mistake was due to a labeling error by the photo's providers, Getty Images and CNN. The correct photo of Sullivan appears at left.

In "Fidelity's help for mutual-fund investors" (BusinessWeek Investor, May 27), we incorrectly reported that Charles Schwab offers some clients an online service allowing them to trade mutual-fund shares by individual tax lots. Schwab expects this service to be introduced in 2003.

"Hard landing ahead for ScanSoft" (Inside Wall Street, July 15) said that Xerox Corp., which owns 20% of ScanSoft, accounts for 14% of its revenues. ScanSoft says the relationship with Xerox is conducted "at arm's length" and that Xerox contributed "substantially less than 10%" to revenues in 2002.

In "Cloning: Huckster or hero?" (People, July 1), we incorrectly reported that Geron Corp. had filed a claim with the U.S. Patent Office charging Advanced Cell Technology (ACT) with infringing the patents that Michael West (Geron's founder and now head of ACT) helped Geron win. Geron has filed an interference claim with the patent office, though not for a patent obtained while West was at the company.

mate clients: the millions of public-company stockholders in the world.

Miles Nathan
Los Angeles

As an Andersen employee, I agree that the demise of our firm will bolster professionals in dealing with unethical clients. There is a darker lesson. Andersen cooperated with Congress and the Justice Dept. in getting to the root of Enron's problem. Acting in good faith, we gave the government its case and its star witness. The next firm in this situation will not make the same mistake.

John K. Dirlam
Wellesley, Mass.

WHY THIS CEMENT PLANT WON'T HARM THE ENVIRONMENT

In "How green should the Hudson Valley be?" (Letter from New York,

July 1, in some editions), Patricia cites some excellent reasons why cates of "smart growth" in the River Valley support a new power in Bethlehem, Pa., and a news cycling plant in Albany, N.Y. projects use existing brownfields incorporate efficient technologies utilize pollution-control equipment are precisely the attributes of Lawrence Cement proposal to replacement plant at Greenport.

St. Lawrence plans to locate facility in an existing quarry and incorporate efficient technologies and air controls. Although Smith up images of 19th century factories, 21st century technologies will be at St. Lawrence Greenport facility, the most environmentally friendly plants in the world.

Phillip Lochbrunner, Vice-President
Major Capital
St. Lawrence
Hudson

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MUCKRAKING!

The Journalism That Changed America

Edited by Judith and William Serrin

New Press • 392pp • \$25

A TOUR OF JOURNALISM AT ITS BEST

In 1905, journalist Ray Stannard Baker reflected that his probe of railroads had given him a new respect for bookkeeping. "Some one should write a book on the 'Marvels and Possibilities of Astute Accounting,'" he archly suggested. Sound familiar? Some things, it seems, never change.

Baker's musings appear in his five-part series on the railroads written for *McClure's*, the turn-of-the-century magazine whose name became almost synonymous with investigative journalism, or "muckraking," as it was known. In terms of clout, the railroads were the tech sector of the 19th century. In fact, railroad barons such as James J. Hill and Edward H. Harriman wielded vastly greater power over communities and customers—making and breaking people with gusto—than do tech titans Lawrence J. Ellison and William H. Gates III. The railroads cut preferential deals with some large shippers, colluded with one another to drive up rates, bribed politicians, and engaged in fraudulent financing and accounting schemes. One reader of Baker's work was President Theodore Roosevelt, who called on Congress to pass tough regulatory constraints. The *McClure's* series helped create a public climate that persuaded Congress to give the existing Interstate Commerce Commission new powers.

Muckraking! The Journalism That Changed America, edited by Judith and William Serrin, is a highly readable collection of such history-changing articles from the mid-1700s to today. The Knight-Ridder editor and New York University journalism professor have put together a celebration of a particular brand of reporting: investigative, passionately polemical, and deeply rooted in the American reform tradition. For instance, in the early years of the republic, journalists such as Frederick Douglass rallied public opinion to end

slavery, while Edwin Markham pushed child-labor reform laws. More recently, Seymour M. Hersh described illegal CIA spying in the U.S., and Randy Shilts heightened public awareness of AIDS. Although "muckraking" was coined as a term of opprobrium, the authors feel that it should be an accolade. They approvingly quote the famous maxim that the job of a journalist is to comfort the afflicted and afflict the comfortable.

The book is divided into 13 sections, ranging from "The Poor" to "Politics" to "America at War." Many of the articles are well known, such as Ida M. Tarbell's 19-part exposé of John D. Rockefeller and the Standard Oil Co. that was published in *McClure's* from 1902 to 1904. There's also one of the hundreds of Watergate articles penned by *Washington Post* reporters Carl Bernstein and Bob Woodward. Among the other well-known names in the volume are John Steinbeck, Drew Pearson, Edward R. Murrow, Nellie Bly, Lincoln Steffens, and David Halberstam.

But I was particularly intrigued by the writings of some less well-known reporters, often in smaller publications. Take, for example, the article published on June 7, 1985, by Arthur Jones in the *National Catholic Reporter*, an independent weekly. Its headline was "Priest child abuse cases victimizing families; bishops lack policy response." The story, told in straightforward language, is buttressed by a steady accumulation of fact and analysis. It makes for depressing reading. The *NCR* revisited the topic many times, and the national media picked up the story about two years later. Raised as a Catholic, I've followed the pedophile scandal with

interest, including the recent Conference of Bishops in Dallas. Reading this article, I felt that a priest or bishop could credibly claim not to know what was going on, but just didn't care.

Another fascinating tale concerns the role played by the *Chicago Defender*, America's great black migration newspaper, nothing but 25¢ in capital, a cane and a borrowed chair, Robert Abbott founded the *Defender* on 1905. Within a decade, it became the most important black newspaper in the country. In 1915, the paper started leading Southern blacks to escape persecution by moving north. The *Muckraking!* notes that Southern employers worried that they were losing valuable labor and tried to discourage black flight by stressing the

mate up north. The *Defender* responded: "I have been a thousand times. It was true, the chances of being lynched by the fingers of the South were greater than to stay in this mortal coil at the hands of the lynchers' hands." The crackling of the lynchers' fire brands.

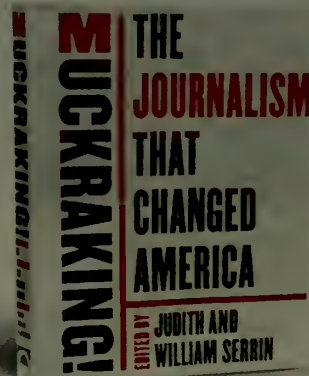
There are disparities. For instance, there are few ink-

wretches representing a liberal point of view. The volume also slight the critical contributions made by business journalists in the past quarter-century. Books such as Alan Abelson's *Sloan*, James B. Stewart, and Welles have all practiced a brand of journalism that exposed wrongs afflicted the comfortable, and influenced public-policy debates.

Still, it's heartening to see how diverse are the media outlets that produced sterling work. Yes, there's the *New York Times*, the *Washington Post*, and CBS. But there are also the *Forks* (N.D.) *Herald*, *Jewish Forward*, and *Harper's*. Journalism has many faces, and the media does focus on superficial schlock. But the real gems in this book remind us how strong U.S. journalism can be.

BY CHRISTOPHER F.

Farrell is a contributing editor.



FROM RAILROAD CHEATS TO PEDOPHILE PRIEST A TROVE OF HISTORY-CHANGING STORIES



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BY ANDY REINHARDT

tech&you@businessweek.com

IT'S ALL GREEK TO THESE SITES



Web translators work for a word or two. But beyond that, hire a human

Imagine you spent weeks scouring the Web digging up data for a research project, and you finally hit pay dirt: The perfect document that explains everything...in Dutch! Something similar happened to me recently, and since I don't speak the language of Rembrandt and Erasmus, I was inspired to check out the dozen free Web sites that translate various tongues.

That's the lure such sites dangle in front of the linguistically challenged. In reality, though, most of them are come-ons from companies that sell translations done by humans or by computer servers that handle large-scale translation projects. The freebies offer quickie translations of Web pages and small chunks of text. Sometimes you can choose from as many as 20 languages, but often only English and a few others are available.

Considering that they're free and entirely computerized, most of the sites do a reasonable job. But at times, I found myself wondering whether their main purpose was to highlight why you ought to pay the big bucks for reliable human translations.

In fairness, the more honest sites don't overpromise. Services like Worldlingo.com and Alis Technologies' Alis.com make it clear that they're only able to provide, at best, the gist of the meaning—not a bona fide rendition. Indeed, a whole new term, "gisting," has emerged to describe the rough and often hilarious results of machine translation. Alis has even given its service the clever name "Gist-in-Time" translations.

There are some important caveats about online translation sites, though. First, you absolutely cannot count on them for important business communications. Even the best make frequent errors that can render their results nearly incomprehensible—and potentially catastrophic.

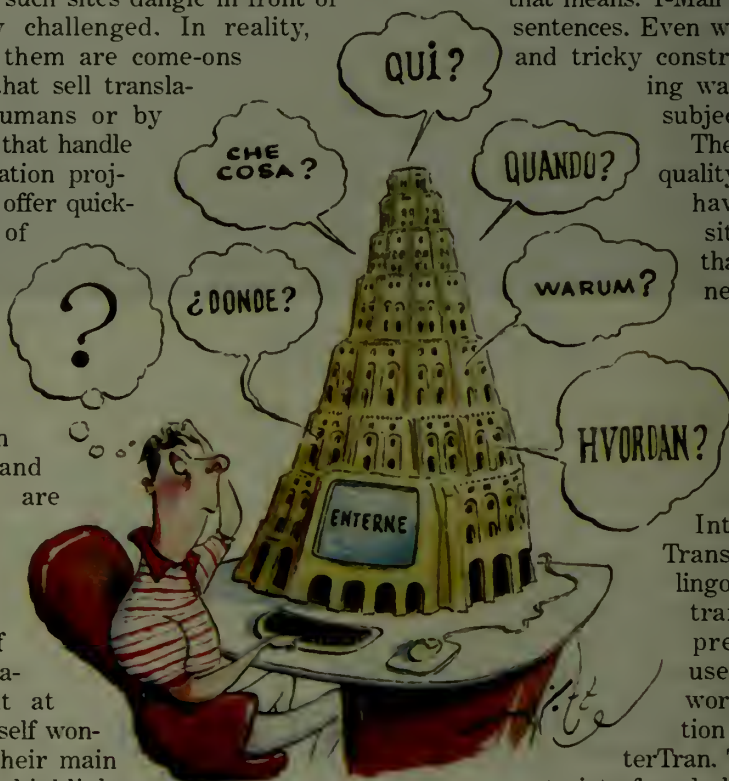
For instance, the previous sentence, send a round trip through Worldlingo, where I sent it from English to Portuguese and back, came out as: "Exactly better they make frequent errors that relieve its results all comprehensible—and catastrophic po Worldlingo did far better with French a man, returning almost perfect translation you have to send a crucial letter to some another country, you still need to shell a professional.

What about using automatic translation for casual e-mail or chatting? I tried one called T-mail.com, that offers a simple interface. You type your e-mail and cc the T-Mail, which forwards a translation to the recipient. Unfortunately, the results weren't accurate. A note sent to me by an Italian colleague included such memorable phrases as "The the below trees comes hidden to the loofanciull from one often tendaggio"—which means, T-Mail also truncates sentences. Even when I avoided complex and tricky constructions, the meaning was often lost in translation.

The wide variety of quality means you have to try several sites to find the one that best handles your needs. I found Systran Software's the tech used by Google and consistently performed International's Translation.com.

Worldlingo also uses the Systran engine, but preferred Systran's user interface. The worst I found: Translation Experts, from InterTran. The site has a pretty interface decked out with flags and offers languages not found elsewhere, such as Polish and Turkish. But four out of five times I tried to reach it, I was turned away with a message that was both boastful and cryptic: "many translation requests by millions of Please click here again later." Ugh. When I did manage to reach the site, it was unbearably slow and the results didn't make the grade.

The sad truth is that machine translation isn't ready for prime time. It's terrific for converting individual words and does provide a gist of foreign language texts and Web sites, but try it. Just don't trust it for business or on the World Wide Web—or, as one site translated the Canvas Through Everyone.



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BY ROBERT J. BARRO

PLEADING THE CASE FOR A PAID-JURY SYSTEM



VERDICT:
As with civil
servants and
judges,
decent pay
for jurors
would help
attract
qualified
candidates

I have often wondered why we rely on conscription to staff our juries. Why not use the market and pay competitive wages to attract willing workers, as we do for judges and other government employees?

Admittedly, my interest was sparked by my recent call for jury duty in Cambridge, Mass. I was first rejected by the lawyers in a personal-injury case involving an automobile accident. Comparing notes later, we potential jurors discovered that anyone who knew anything about costs or the medical profession had been screened out—an economist, an accountant, and two nurses.

Later, I qualified for a jury in an assault case. After we had been seated, the judge's first words were: "Mr. Barro, I would like you to serve as foreman of this jury." My initial reaction was that the judge had magically perceived my qualities of intellect and leadership, but then he said: "It really doesn't mean anything, you just happen to be sitting in the foreman's seat. All you have to do is sign the form for the verdict." After this fine start, my jury experience went satisfactorily, but I think the national product would have been higher and I would have been happier if I had stuck with my day job.

Jury conscription is similar to the military draft, which we had in the U.S. until 1973. At that time, there was a great debate about the benefits and costs of eliminating the draft. The benefits are similar to those of free markets in any sector. Notably, if the military pays competitive wages, then the people who serve are the most willing and able, taking account of their alternative occupations and the government's willingness to pay. The government, in turn, sees the budgetary costs of having a larger and better military and appropriately weighs these costs when determining the number and qualifications of its recruits. In contrast, the courts see little cost in conscripting hundreds of potential jurors, many of whom waste their valuable time by sitting around without ever being empaneled.

One concern was that the elimination of the military draft would result in poorly qualified personnel who came disproportionately from minority groups. Of course, if the military wants highly qualified people—for example, with college degrees or specific skills—then it has only to pay the appropriate wages. I am unsure why the representation by race or ethnicity should be a concern, but this issue seems also to disappear when military wages are satisfactory.

Another fear was that the budgetary cost

would be excessive. However, the draft lowers the true costs—it just taxed the who were drafted. This tax is especially burdensome when it affects only a minority population in a random manner. In any event, the abolition of the draft—President Richard Nixon's finest hour—has worked out well and would advocate a return to conscription.

The jury system raises the same issues. Proponents of the current setup claim that it ensures a "jury of one's peers," but a paid system would result in overrepresentation by the poorly educated and unemployed. However, as is the case with judges and civil servants, a paid system would get people with the qualifications the government wants. For instance, if we want some jurors to have college degrees, then we could pay them necessary wages.

There may be some benefits from selecting jurors through random procedures, although these benefits are partly eliminated in the present system by allowing peremptory challenges to attorneys. For example, randomness may create heterogeneity with respect to socioeconomic characteristics, depending on how the pool of potential jurors is determined. However, relying on a market system prevents random selection among persons who offer to serve at atractive wage.

Another view is that there is something special about the people who would voluntarily work as paid jurors. But it is hard to see why this argument applies more to jurors than to judges and civil servants. There is also the claim that jury service is a part of citizenship, yet I cannot see why this applies less to teachers or postal workers, who have not been subject to conscription. Finally, juries have been argued to be a check on the power of government, represented by prosecutors and judges, but I am not convinced that competitively paid jurors would be less effective in this role.

My suggestion is that some jurisdictions experiment with paid systems for jury service. In a jurisdiction, those who enlist for juries should be paid market wages. The system could be financed within the jurisdiction or, alternatively, through the states or Washington. Different lengths of service would likely be offered, with a maximum tenure of perhaps one year out of three. Another idea is the elimination of jury duty in civil proceedings. As with the abolition of the military draft, the elimination of the jury duty is likely to be sound policy.

Robert J. Barro is a professor of economics at Harvard University and a senior fellow of the Hoover Institution (rjbweek@harvard.edu).

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BY MARGARET POPPER

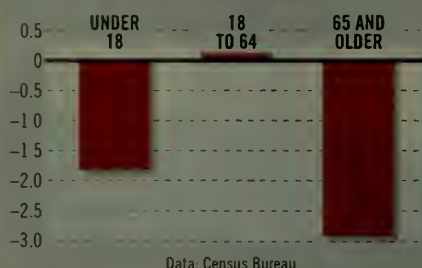
THEY REALLY WERE GOLDEN YEARS

Seniors prospered in the '90s

Anger over mounting medical bills has obscured a simple fact: The elderly prospered in the 1990s. According to new census data, poverty among those 65 and older fell much faster than among other age groups during the decade. Seniors did have higher medical expenses. But that was

ELDERLY POVERTY PLUNGES

Percentage point change in poverty rate from 1989 to 1999



offset by income gains. Just 9.9% of the elderly were below the poverty line in 1999, down from 12.8% in 1989 (chart) and 25.3% in 1969.

Other age groups did not fare as well in the 1990s. The poverty rate for children under 18 dropped from 17.9% to 16.1%—a big decline, but still smaller than the drop for the elderly. And the poverty rate for ages 18 to 64 actually rose slightly, from 11.2% in 1989 to 11.3% in 1999.

Many people who retired in the 1990s absorbed only a small hit to their living standards. The average replacement ratio—retirement income as a share of peak aftertax lifetime income—approached 87% in 1999, reports a study by James P. Smith, a Rand Corp. economist. That's up from about 80% in 1989.

For the poor, the transition to retirement was especially seamless: After paying taxes, households in the lowest 25% income bracket had retirement income equal to pre-retirement income, reports Smith. The bear market in stocks affected only the top 30% or so of America's elderly. "The remainder never had much wealth," he says. As a group, "this [current] generation of elderly will probably have it the best of any generation, either before or after,"

says Edward N. Wolff, New York University economist.

In fact, there are signs that the current decade is not shaping up as well for old people. Unlike in the 1990s, rapidly rising health-care costs are not expected to be offset by rising retirement incomes. By 2005, the elderly will spend 25% of their income, on average, on medical expenses, including premiums for Medicare, estimates Marilyn Moon, a senior fellow at the Urban Institute, a Washington think tank. That's up from 22% in 2000. "Health-care costs will continue to rise as a share of people's incomes, no matter what," she says.

IS THIS TAX CUT CUTTING IT?

Long-term, it may mean less savings

Tremendous dispute still exists among economists about whether the 10-year, \$1.4 trillion tax cut signed by President George W. Bush in June, 2001, will be good for the U.S. economy over time or not. A study by Alan J. Auerbach, an economist at the University of California at Berkeley, suggests that the tax reduction could boost the net national savings rate in the short term but lower it in the long run, possibly slowing economic growth.

The net national savings rate is a share of gross domestic product excluding depreciation. It includes such things as personal savings and undistributed corporate profits, minus government budget deficits. If spending behavior doesn't change, the tax cut would do nothing to alter the national savings rate. Any increase in household after-tax income would go right into savings. But that would be offset dollar for dollar by a rise in the federal budget deficit.

Auerbach, however, argues that spending behavior will change. He says people in the short run likely will save more than a dollar for each extra dollar they get from the tax cut, taking advantage of higher disposable income now to salt away more money. This scenario—one of several in his study—assumes that Congress won't change the tax law before 2010, and that afterward, Congress will wipe out the deficit solely by raising income taxes. Since people know the windfall won't last past 2010, there will be an extra impetus to save now, says Auerbach.

After 2010, Auerbach thinks the na-

tional savings rate will start eventually dropping well below level. That, he thinks, will make it harder to finance investment and the long-term growth rate of the economy. Auerbach's compromise: Delay such big deficits. Make smaller permanent tax cuts.

AMERICA THE TRANSPARENT

Accounting is even worse else

Bad as the recent accounting scandals in America have been, companies still report their profits more accurately than those in any other country, shows a study by financial analysts Utpal Bhattacharya of Indian University and Hazem Daouk of the University of Michigan, and accounting professor Michael Welker of the University in Kingston, Ont.

Using data from nearly 60,000 companies from 1985 to 1998, the study ranked 34 countries on three criteria: "earnings aggressiveness," booking gains early and losses late to avoid them; "earnings smoothing," using results to turn small losses into gains; and "earnings transparency," the books to suppress both large and large losses. The more companies a given country exhibited any of the traits, the lower the country's earnings transparency ranking.

The U.S. had the highest ranking for earnings transparency, and it ranked among the top six countries on each of the three criteria. Its lowest ranking, sixth, was on earnings aggressiveness.

So far, the U.S. reaps the advantage of a lower cost of capital from the perception of transparency. Bhattacharya estimates that the cost of capital is about 3% lower for a typical country in the top half of the rankings than for one in the bottom half. Bhattacharya also says that although he doesn't have international data since 1998, he believes that U.S. companies still have the most transparent accounts, scandals notwithstanding.

THE U.S. SETS THE STANDARD

Earnings Transparency of the G-7

RANK	COUNTRY
1	U.S.
7	CANADA
8	FRANCE
11	BRITAIN
15	GERMANY
27	ITALY
29	JAPAN

*Rank among 34 countries based on how well profits reflect actual earnings.

Data: Bhattacharya, Daouk, Welker

BY JAMES C. COOPER & KATHLEEN MADIGAN

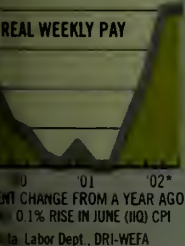
CORPORATE CRIME ISN'T FAZING CONSUMERS. YET

But, they're watching the stock and labor markets—and their wallets

U.S. ECONOMY

The U.S. economy has always been characterized as a marvellous enterprise. Right now, the designation is appropriate than usual. That's because two markets—stock and labor—will be critical in driving future consumer spending and, thus, the economy as a whole. What worries some economists is that the stock and labor markets will drive the recovery right into the ground. Consumers could hold back in the second half, partly out of their disillusionment with the stock market and partly about a weakening labor market. Bear in mind that consumers have been the wellspring of demand over the past year, both through their purchases of goods and services and by their willingness to buy more. If households reduce their spending, the recovery will struggle in coming quarters.

WEEKLY PAYCHECKS OUTPACE INFLATION



Right now, it seems unlikely that the stock and labor markets will bring down the recovery. The latest jobs report shows that the days of massive layoffs are over, and workers are reaping pay raises that still outpace inflation (chart). The prospects for the stock market are more problematic. Still, households began to take the hit to stock

prices back in 2000, and real consumer spending managed to grow by an impressive 4.2% in 2000 and an additional 3.1% in 2001. At the same time, though, job growth and equity gains won't be the rocket boosters for spending as they were back in the years prior to the 2001 recession. Without the extra fillips, consumer spending will grow only as aftertax income does, or probably by about 1% in the second half. That pace, while modest, is fast enough to keep this recovery on solid footing.

CORPORATE CORRUPTION

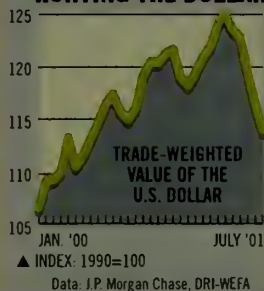
Corporate corruption isn't new, but the sheer number of cases today raises legitimate questions about its effect on consumer confidence. President George W. Bush recognized this risk in his speech on July 9. "The misdeeds of Corporate America, he warned, are threatening the financial well-being of many Americans and investors." The President proposed stiffer penalties for fraud and tighter oversight by corporate boards, but at this early stage, the financial

markets were unimpressed with his agenda (page 26).

But just as shoppers mostly shrugged off the market declines of 2000 and 2001, they have basically taken the scandals in stride. Weekly store surveys indicate retailers did well in June. And vehicle sales rose to an annual rate of 16.4 million last month, up from 15.5 million in May. The steady advance in spending suggests the risk of a consumer pullback is still small.

A bigger, albeit less appreciated, danger from the corporate mess is the effect it is having on the dollar. Foreign investors view U.S. securities as less attractive now than they did last year, when the economy was officially in recession. The pullout of foreign money from the U.S. financial system is weakening the dollar, which has fallen some 9%

BUSINESS SCANDALS ARE HURTING THE DOLLAR



on a trade-weighted basis since February (chart).

A weak currency leads to higher import prices. By June, prices of nonoil imports had increased for three of the last four months. The rise will allow U.S. producers of similar goods to lift their prices as well. After years of extremely low inflation, the U.S. could face a steady climb in prices, perhaps as early as next year. Rising inflation is a drag on household budgets, causing it to be the second-biggest economic concern for consumers.

CONSUMERS' BIGGEST WORRY

not surprisingly, is joblessness. That's why healthy labor markets are key to the consumer outlook. Rising job prospects can often offset household discontent over a falling stock market. The latest employment report shows the labor markets are improving, although hiring has been slow to pick up after the recession. Nonfarm businesses added 36,000 in June, on top of a 24,000 gain in May. But the Labor Dept. revised down its previous data, so payrolls this year have been basically flat.

Despite that, the June unemployment rate was only 5.9%, a low reading right after a recession. And given the falling trend in new claims for unemployment benefits, joblessness should remain below 6%. That's a turnaround from the end of 2001 when some forecasters expected the rate to hit 6.5% or higher this year.

Two other good signs for the job outlook: Temporary-help jobs increased by 9,000 in June, the fourth gain in

Business Outlook

a row. And businesses lengthened the workweek in June. Both trends are precursors to the hiring of more full-time workers. In addition, factory layoffs were much less severe in the second quarter than in the previous five quarters. And June factory overtime edged up to 4.3 hours, the largest amount in 1½ years. Those data indicate that the manufacturing recovery continued to strengthen in June.

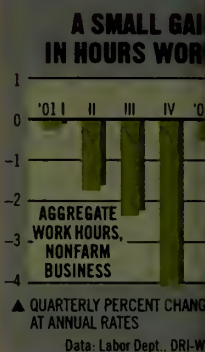
Thanks to the longer workweek and the increase in payrolls, aggregate hours worked in the economy rose slightly in the second quarter, the first advance since late 2000 (chart). The small gain in hours means productivity posted another good increase in the second quarter. But the rebound in work time suggests that businesses are beginning to rely partly on labor, not totally on productivity, to increase output.

THE UPSIDE of the continued productivity boom is that employees, on average, continue to enjoy healthy pay raises. In June, hourly pay for nonfarm production workers rose 0.4%, to \$14.76. Add in the longer work time, and weekly paychecks are up 3.6% from the year before. Even with the runup in energy costs in the spring, real weekly pay grew about 2.1% in the year ended in the second quarter. The recent fallback in fuel prices suggests that buying power will advance further in the second half. The extra cash should support future gains in consumer spending.

Trends in the stock and labor markets will drive consumer spending. They'll also influence monetary policy to some extent. To be sure, the Fed will not cast itself as a savior for Wall Street. Short of a systemic financial crisis, don't expect it to help out the stock market. But policymakers are aware that declining equity prices reduce financial capital spending and curb household wealth. The stock market's fall will surely be a topic of discussion when policymakers meet four more times this year.

On the labor front, the Fed will probably wait for a clear downtrend in unemployment before it starts to raise interest rates toward a neutral stance in which rates neither promote nor hinder economic growth. Given the slow pace of new jobs, that move is a long way off. More economists are pushing their expectations of the first Fed rate increase into 2003.

By that time, corporate scandals will be old news. At least, that's the hope. However, with the labor market improving and the Fed still on the sidelines, consumers seem unwilling to let the corporate crime wave affect their spending plans.



EURO ZONE

THE PERILS OF RISING LABOR COSTS

A rising euro and cheaper energy are easing price pressures in the euro zone. But that could be short-lived. Labor costs are outpacing inflation, and the latest round of union wage agreements is set to keep upward pressure on business costs and slow an already fragile recovery.

In the first quarter, labor costs in the euro zone rose by 3.9% from the year before, up from their 3.4% gain in the first quarter of 2001. Broken down, wage growth jumped 4.1%, while the cost of benefits and taxes rose 3.1%. The acceleration in euro-zone wages is in contrast with trends in the U.S., where compensation growth is stalling.

And labor costs won't ease anytime soon: Wage agreements this year in Italy and Spain have exceeded 2%, while German unions won immediate lump sum payments of up to 210 euros (\$207) per worker, along with pay raises of 3% to 4% for this year and 2003.

The pay gains have yet to spur consumer spending. Monthly retail sales for the euro zone unexpectedly slipped 0.6% in April. And the European Commission's June

consumer confidence index fell to -9, from -8 in May.

Meanwhile, the factory sector's nascent recovery is weak. Manufacturing activity expanded for a third straight month, rising to

51.8% in June. Still, manufacturers trimmed payrolls, and input costs rose at the fastest clip since January, 2001. Factories are facing a squeeze. The 11% jump in the euro so far this year is making imports more price competitive and hurting exports. Unlike service-producers, manufacturers hold little pricing power. With few options at hand, factories most likely cut more jobs.

Rising labor costs, as well as the weak industrial sector, put the European Central Bank in a bind. Even as June consumer prices are expected to dip below the 2% target set by the ECB, the bank continues to see considerable upward pressure on prices. The ECB meets again in September, but an interest-rate hike then could still be too early.

By James Mehrling in New York

COMPENSATION GAINS REMAIN STRONG



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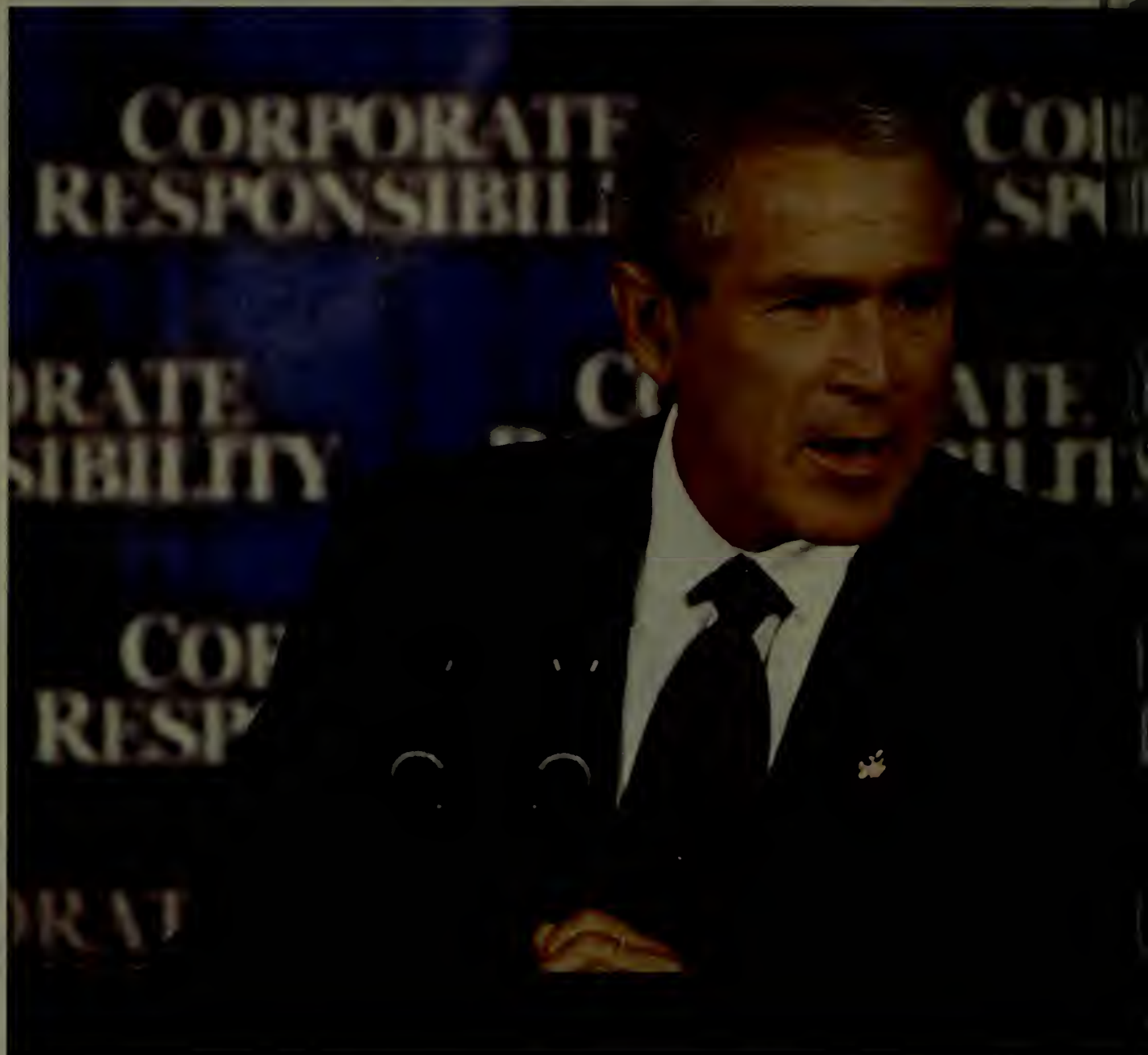
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LET THE REFO

*As America's
anger grows,
the time for talk
is long past*

At the core of every American reform movement there is a short, smoldering fuse of populist resentment—outrage over the arrogant elite of corporate malefactors and, often, alarm over the industrial octopus whose tentacles seem to menace the unprotected worker. In bygone days, symbols of unchecked power included land-grabbing rail barons, Midwestern meatpacking combine, steel trust, Standard Oil, and rapacious Wall Street financiers. Compared with the errant tycoons of yesteryear, Bernard Ebbers, former CEO of WorldCom Inc., seems a wan pretender. But give Ebbers some credit: He may just be a fulcrum of



S BEGIN

mic history. The brash Mississippi exec is proving to be a catalyst for what all the New Reform Era—the most ambitious drive to overhaul financial es in generations.

ing is critical, of course, and Ebbers' was exquisite. Coming on the heels of e of accounting scandals that demoralized investors and weakened the econ- WorldCom's \$4 billion stunner did what legions of Democrats could not: It lent rtisan cast to the budding reform drive and compelled a reluctant White to join the campaign for revamped business ethics.

haps more important, it shocked CEOs into accepting reality: Anger over shady eeping and stock promoting is not a transitory irritant that lobbyists can

Cover Story

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Bush sounds the alarm

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Justice's Larry Thompson

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Nice speech, but no cigar

CAN WORLD COM SURVIVE? 38

CEO Sidgmore's battle plan

soothe with the traditional emollients. That means Big Business has to embrace new ethics guidelines or face the specter of rules drafted by a panicky Congress.

The response has been electric. Among the corporate ethics policies sprouting up are voluntary codes of conduct from the Business Roundtable, the U.S. Chamber of Commerce, the Securities Industry Assn., and the stock exchanges. These changes from deep within the business culture, coupled with heat from Washington, mean that CEOs are in for a fairly hefty slug of reform.

At a minimum, accounting practices seem destined for systemic change. Corporate-governance standards are in the offing, and the drumbeat for accountability grows louder by the day. In this new climate, when even a hint of irregularities can send a stock plummeting, investor activists have greater leverage. They will use it to lobby against abuses such as bloated executive-pay packages, massive stock option grants that aren't counted as compensation expenses, and snoozing directors.

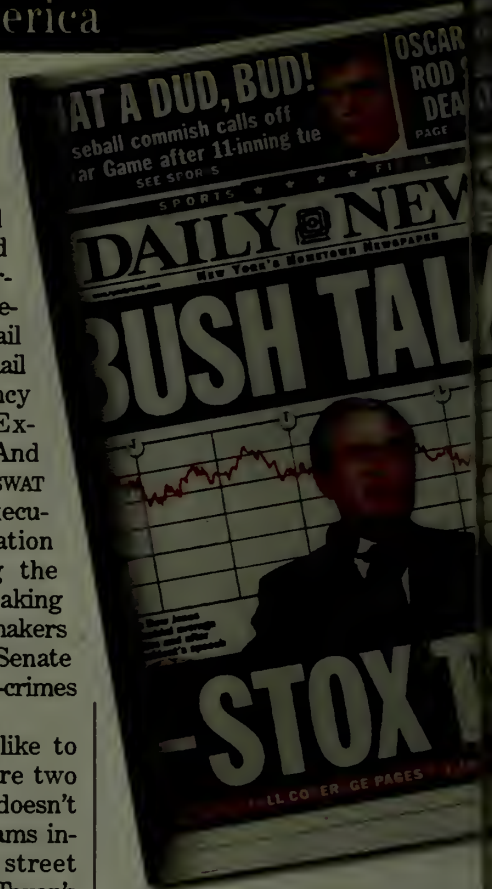
Business' drive for a "best practice" code of conduct is laudable but not sufficient, declared the new Reformer-in-Chief on July 9. "Self-regulation is important, but it's not enough," President Bush told Wall Street execs. "We must

usher in a new era of integrity in Corporate America."

True, many of his remarks sounded like a Sunday morning morality lecture. But Bush did more than sermonize. He backed proposals to compel CEOs to guarantee the accuracy of financial statements. He called for doubling jail terms, to 10 years, for wire and mail fraud. He asked for an emergency \$100 million for Securities & Exchange Commission enforcers. And he unveiled a new Justice Dept. "SWAT team" aimed squarely at the executive suite. "My Administration will...end the days of cooking the books, shading the truth, and breaking our laws," Bush vowed. And lawmakers go the message: On July 10, the Senate approved Bush's tougher financial-crimes penalties 97-0.

Clearly, the President would like to bury the perception that there are two classes of criminals. "The public doesn't distinguish between corporate scams involving billions of dollars and street crime," says Matthew Dowd, the Texan's campaign pollster. "But up until now, it seemed like the Wall Street guys were less likely to get punished."

Although Bush's "hang 'em high" tone was telegraphed days in advance, the financial markets weren't wowed. A



new round of disappointing reports sent stock indexes p
"A lot of these reforms will
lowering expected earnings
Thomas D. Gallagher, senior m
director of consultants Inter

Business Reform: What's Real...

AN INDEPENDENT ACCOUNTING BOARD

► A new overseer for accountants seems to be a given. But there will still be partisan tussles over how much clout it should have. For the moment, Democrats have the momentum in pushing for a tough board with full-time members and wide-ranging disciplinary powers. That may not include subpoena power because of concerns that a new set of quasi-cops would overlap the SEC's jurisdiction.

A MORE MUSCULAR SEC

► President Bush has joined the congressional stampede to beef up the SEC's budget. An air-drop of cash—the President will seek \$100 million, on top of the \$487 million he had approved for next fiscal year—should help agency investigators accelerate accounting probes.

CEO/CFO CERTIFICATION

► Top execs will be required to personally certify the accuracy of financial statements. Business is biting its lip and going along, but many CEOs fear a rash of lawsuits will result.

A VOTE ON STOCK OPTIONS

► Congress, the stock exchanges, and the SEC all favor requiring shareholder approval of stock-option awards.

AUDITOR INDEPENDENCE

► The President endorsed an SEC effort to bar accountants from most consulting for audit clients. But the rules board audit committees hire a company auditor for work—a big loophole. Even the tougher Senate bill, most nonaudit services, lets companies seek an SEC to hire their auditor for consulting work. Dems are likely to muster the votes to require accountants to rotate lead auditors—not the entire firm—every five years and to ban them from auditing companies if they have employed the

MORE OUTSIDE DIRECTORS

► Bush now insists—as reform groups have for years—that boards should have a majority of independent directors. Only independent directors serve on audit, compensation, and nominating committees. Reformers also agree that boards should have the power to hire and fire auditors and to veto any consulting contracts awarded to audit firms.

CURBS ON INSIDER SALES

► Congress is likely to restrict sales of stock by company insiders. The SEC already has said it will require insiders to report stock sales within two days.

Investors need to be convinced that [corporate] abuse is not widespread.... This problem can't be solved with a single speech "

— LYNN REASER, Chief Economist, Banc of America Capital Management

gy & Investment Group. "CEOs are going to be personally liable for lying financial statements. That's going to produce earnings reports that are on the low side."

Conveniently, Bush's latest action plan is a sort of Democrats' demands for sweeping measures. "A fresh coat of paint on rotten wood," huffs Representative Lloyd Doggett (D-Tex.).

Partisan jousts aside, the speech marks a turning point. Suddenly, Democrats and Naderites aren't the only ones calling for real change in Corporate America. The converts to investor-class liberalism now include: arch-deregulation George W. Bush; a big bloc of Sen. Republicans who have switched and now support the accounting reform bill of Senator Paul S. Sarbanes (D-Md.); a growing group of House conservatives who sense a political risk in letting corporats; and business leaders who have come to accept reforms in corporate governance and accounting as a means of restoring confidence. Says CEO Richard H. Brown of Electronic Data

Systems Corp.: "This has been a painful but necessary wake-up call. In the long run, we will all benefit."

In the short run, execs are dutifully falling in line behind Bush. "He did the right thing," says Charles D. Morgan, CEO of Acxiom Corp., a Little Rock data-mining outfit. "As we gain more confidence in business leaders, we'll gain more confidence in the economy."

Still, there is unease about increasing managers' liability—not to mention the galling thought that Democrats keep upping the ante on financial regulation. Cautions CEO Arthur D. Levinson of Genentech Inc.: "We need to be careful that we don't put into place mechanisms that will stifle the growth of the majority of companies that are honorable."

While there is some reason for skepticism about how effective the current reform drive will be, there is no doubt at all about what is driving the nation's fervor for change. On the economic front, the news that even a blue-chip outfit such as Merck & Co. has boosted revenues with aggressive accounting is keep-

ing many investors on the sidelines. "The healing process is going to take time," says Lynn Reaser, chief economist at Banc of America Capital Management. "Investors need to be convinced that [corporate] abuse is not widespread and that accounting standards are being improved.... This problem can't be solved with a single speech."

What will it take? Bush advisers hope the new SWAT team can quickly round up some high-profile villains to parade before cameras. "The most important thing is to get a bunch of CEOs and directors and throw 'em in jail," says one exec who is close to Bush.

On the political front, the pervasive nature of the scandals has the potential to transform an issueless November election into a referendum on corporate reform—a development that could capsize some pro-business Republicans. Now that Democrats are vying to make the GOP's deregulatory permissiveness and its supposed indifference to worker pensions the galvanizing issues, Republicans are starting to worry that the

... What's Rhetoric—Or Just Unlikely

LOCKING UP CEOs AND CFOs

Prosecution of top execs for knowingly signing off on false financial statements has a chilling effect in theory. But Bush's call for stiffer sentences, proving intent remains difficult. What's more, juries are often confused in complex financial-fraud cases, and corporate lawyers use top legal talent to shield them from jail time.

DISGORGING ILL-GOTTEN GAINS

Efforts to require CEOs to give up ill-gotten gains—stock bonuses based on false earnings—gives the SEC what it already has. Despite hundreds of company restatements and dozens of SEC investigations for accounting lapses, only four cases so far requested disgorgement in only four cases so far. Investors rarely see any of this money.

A BAN ON MOVING OFFSHORE

Legislation is hoped to attach an amendment to the Senate reform bill that would ban U.S. companies from moving headquarters offshore to avoid taxes. Democratic leadership worries that too many amendments will weaken GOP support for the core reform measure. Upshot: Shifting corporate tax havens solely for tax avoidance remains an option.

LIMITING COMPANY STOCK IN 401(k)s

► Liberals sought to restrict companies' right to match employee contributions with company stock. But the drive fizzled when employers threatened to end company matching if they couldn't use their own shares. Employees also balked at an artificial cap.

EXPENSING STOCK OPTIONS

► Some headway had been made on reformers' efforts to mandate that the cost of stock options be deducted on income statements. But tech industry objections have convinced many Democrats that expensing options would stifle growth.

OVERSIGHT OF DERIVATIVES

► These unregulated financial instruments played a big role in Enron's questionable energy trades. Aggressive oversight seems unlikely, though, because many business execs say they remain essential to hedging strategies.

REINING IN ENERGY TRADERS

► Democratic proposals to subject energy trading companies to oversight by the Federal Energy Regulatory Commission, or to give it the ability to impose criminal penalties on companies that manipulate power markets, have been rejected.

opposition has finally found a way to frame an economic assault against the GOP. In a June 28-30 Gallup Poll, 77% of respondents called business scandals either a crisis or a major problem. "The debate has shifted," says GOP pollster William D. McInturff. "It's now: 'They cheated. The system is broken. How much do we need to do to fix it?'"

The answer: a whole lot. With everyone from House Energy & Commerce Committee Chairman W. J. "Billy" Tauzin (R-La.) to Senate GOP maverick John McCain of Arizona calling for a crack-down on corporate crooks, it certainly looks as if far-reaching reforms are on

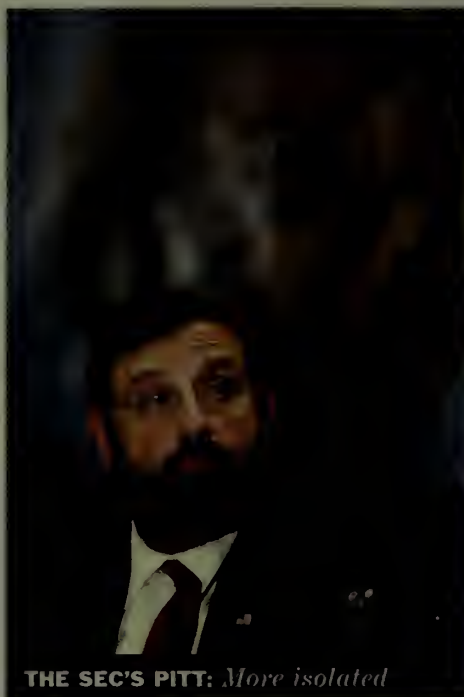
Although Bush still backs him, pressure is growing for Pitt to go

“ [Pitt] should be a trouper and take one for the team ”

— A HOUSE GOP STAFFER

the horizon. But reality is more complex. Most Republican lawmakers hope that unleashing the cops will compel CEOs to clean up their act and lessen demands for new laws. Democrats, however, have momentum on their side. In a strategy shaped by Senate Majority Leader Tom Daschle (D-S.D.), they are pushing tougher reform measures and are daring Republicans to side with Big Business.

After the partisan head-banging, how strong will constraints on companies, auditors, and analysts be? The outlook: ■ **Accounting.** With the Sarbanes bill a cinch to breeze through the Senate, odds for an independent accounting oversight board have brightened. The House has passed an industry-friendly alternative, and the fireworks will start with negotiations over key details. Democrats will push for a totally independent body with wide investigative powers and the ability to set audit standards without domination by the ac-



THE SEC'S PITT: More isolated

counting industry. GOP leaders will be hard-pressed to resist.

The shift toward a stronger oversight board represents a rebuke to SEC Chairman Harvey L. Pitt, who contends that creating a new agency with quasi-legal authority will muddy the regulatory waters and impede fuller disclosure. But increasingly, Pitt is isolated by bipartisan criticism of his past work as a top accounting-industry lawyer. Although Bush continues to back him, pressure for Pitt's resignation is bubbling up on Capitol Hill. "He should be a trouper and take one for the team," says a House GOP staffer.

Pitt is also on the run on another front: Democrats' demands for a legislative ban on accounting firms' performing both auditing and consulting for the same corporate client. Bush now wants the SEC chief to quickly issue rules to restrict the practice, giving a boost to the Sarbanes measure, which

would make such a ban permanent.

Meantime, Democrats have more the votes to force another big change: requirement that companies rotate lead auditor every five years. That discourages sweetheart relationships developing between auditors and companies, such as the one linking Enron and Arthur Andersen.

■ **Corporate Governance.** One Bush proposal with some bite is the call for CEOs to attest to the accuracy of company financial reports. By demanding a higher ability at the top, the Administration hopes to prevent execs from passing the buck, as at Enron, where hedge-fund boss Kenneth L. Lay insisted he had no knowledge of financial engineering at his company. "We have to stand behind what we say," agrees CEO David Burnham of Raytheon Co.

But other execs worry they'll be targeted by trial lawyers and disgruntled shareholders—a fear that Bush and many experts claim is misplaced. Ira M. Millstein, a senior partner at law firm Weil, Gotshal & Manges, says in time, CEOs will find a way to get back to the routine. "It would be a mistake to push this as the end of the world," says. "Yes, it's more of a burden properly handled, it can be discharged."

Investor advocates applaud the belated embrace of changes they have sought for years, such as forcing companies to have a majority of independent directors, granting audit committees the power to hire and fire accountants, banning sweetheart loans to officers and directors, and requiring shareholders' approval for stock option plans.

The New York Stock Exchange is already calling for most of these reforms. Many corporations, such as Wal-Mart and Goldman, Sachs & Co., have taken preemptive steps to improve the independence of their boards. Citigroup CEO Sanford I. Weill is proposing one major move that Bush is backing away from. "You want to know what I would really like to do with options? I would like to ask Weill. 'Expense them for the next five executives.'"

If companies don't clean up the mess, Bush says he's ready to send in the

A Timetable Of Reform

JULY 10 New rules governing research analysts, proposed by the stock exchanges and adopted by the Securities & Exchange Commission, took effect. Among the changes: Wall Street firms may no longer pay analysts for work on specific investment-banking deals, and investment bankers are prohibited from influencing stock ratings.

AUGUST 1 The New York Stock Exchange board votes on whether to approve proposed new corporate governance rules. Among the proposals: independent directors must comprise a majority of boards; compensation, and nominating committee members must be independent directors or stockholders must approve all stock option

The Democrats say Bush's call to action short

A fresh coat of paint on rotten wood

REPRESENTATIVE LLOYD DOGGETT

enning the penalties for corporate fraud and document-shredding, he says SEC and Justice Dept. enforcers have the tools to use against crime in the future. But legal experts say investors are unlikely to see legions of corporate prosecutors busting rocks on the local chain. Even though CEOs will sign those financial attestation statements, proving indefraud is tough for prosecutors in business fraud cases—a job not made any easier by executives' access to defense lawyers.

Lawmakers such as McCain and Senator Judiciary Chairman Patrick J. Leahy say the Administration should go further by creating a new law with a maximum sentence of 10 years for obstructive tactics such as shredding records and creating phony documents. Some dream of overturning the U.S. Supreme Court case that makes it impossible for private litigants to sue lawyers and accountants for aiding and abetting corporate fraud. Others want to modify the 1995 Private Securities Litigation Reform Act, which makes it hard to bring civil suits against officers and directors. "This has been devastating to investors," says Representative John Bryant (D-Tex.), a private lawyer. "It encouraged bad behavior by companies."

Any changes seen as helping triggerers will face heavy flak from corporate chieftains, pro-tech New Democrats and a President who despises the courts' bar. "Will we open up a Pandora's box of lawsuits, civil or criminal? That's my biggest fear," says the CEO of a national bank.



SARBANES AND DASCHLE: For strict oversight

■ **Wall Street Analysts.** Although he lashed out at research analysts who say "buy" when they mean "sell," the President is playing catch-up with Eliot L. Spitzer: The New York Attorney General won a \$100 million settlement from Merrill Lynch & Co. over allegations that the firm's analysts misled investors. And state regulators are now pursuing other brokerage firms on similar charges. Calling the President's remarks a "profound disappointment," Spitzer said that "until the issue of analyst conflicts is addressed [by putting more distance between researchers and bankers], it is incumbent on state regulators to...protect the investing public from continued abuses."

What's more, on the very day Bush spoke, new rules proposed by the stock exchanges and adopted by the SEC took

effect. The rules prevent investment bankers from interfering in analyst recommendations or from playing any role in setting analysts' compensation. Trouble is, Wall Street firms are still resisting taking the extra step—completely separating research from investment banking—that would grant the President's wish of transforming analysts from hawkers to truly independent researchers.

In many respects, the 10-point corporate-accountability plan that Bush unveiled on Mar. 7 and his July 9 addendum are imperfect blueprints. But the details are less important than the fact that both Bush and business are now being swept along by the reform tide. Even as he moves closer to the Democratic position, the President makes his familiar rejoinder that only a few "bad apples" have sullied the reputation of a business leadership that he accurately describes as fairly straight arrows. "The vast majority of CEOs in America are good, honorable, honest people who have nothing to hide," he said on July 8. "It's the few...that have created the stains we must deal with."

But as America's corporate leadership has found out, it only takes a few rotten apples to spoil the barrel. As for the MBA President who glorified the entrepreneurial culture—until Enron triggered the corporate crime wave—fate has been cruel. Now, Bush has had to stop proselytizing and start reaching for the mop and bucket. As the cleanup begins, much is at stake for George W. and the GOP. But even more is on the line for executives struggling to rebuild shattered confidence in Corporate America.

By Lee Walczak, Richard S. Dunham, and Paula Dwyer, with Laura Cohn, in Washington; Wendy Zellner in Dallas; Geoffrey Smith in Boston; and Cyrus Scotti with the President on Wall Street; and bureau reports

14 CEOs and CFOs of companies with more than \$1.2 billion in annual revenue must certify that all financial statements since 2001.

1 The SEC could begin hiring new enforcement officers, and replacing outdated technology, if it allocates an extra \$100 million, as the President suggests. That would be on top of \$487 million already allocated for the 2003 fiscal year.

NOVEMBER 9 Wall Street firms must disclose if they own 1% or more of the stock of any company that is the subject of an analyst's research.

EARLY NOVEMBER Accounting-reform legislation now moving in the Senate calls for a new oversight board to be in place 90 days after passage, or by mid-November if President Bush signs the measure by the August congressional recess.

CORPORATE CRIME'S NEW TOP COP

The Deputy AG will be under pressure to act fast

When Larry D. Thompson was named to the No. 2 position at the Justice Dept., he worked hard not to make a splash. He shunned interviews, gave few speeches, and moved into a modest Washington apartment where he rents everything from the silverware to the linens. In a department full of controversial figures, Thompson set out to be the guy who quietly made things run.

Those days of anonymity are about to end. On July 9, the President tapped the 56-year-old Deputy Attorney General to head his newly minted Corporate Fraud Task Force—"a financial crimes SWAT team," Bush called it. The choice of Thompson as point man on corporate malfeasance was not a hard one. His boss, Attorney General John Ashcroft, has recused himself from the Enron and Arthur Andersen cases. And given the \$10,000 that Ashcroft received from WorldCom Inc. while in the Senate, he may have to drop out of that probe, too.

Besides, Thompson gives Bush what he desperately needs for his war on corporate greed: credibility. Thompson is universally respected in legal circles and has a sterling résumé that includes stints as a U.S. Attorney in Atlanta and a white-collar criminal defense attorney who won an acquittal for a Coca-Cola Co. executive accused of bribing a union official. He carries little political baggage. Thompson's one involvement in partisan politics was his work in 1991 to help longtime friend Clarence Thomas win confirmation to the Supreme Court.

Thompson is almost the antithesis of Ashcroft, who is widely viewed as the ideologue assigned to stroke Bush's conservative voter base. In June, for example, Thompson spoke to Justice employees celebrating gay pride month—an appearance Ashcroft is unlikely to have made. "He's the perfect guy for the job," says former U.S. Attorney for Washington Joseph E. diGenova. "He'll be firm but fair." The big question is how he will stand up in a high-profile political job.



Larry Dean Thompson

POSITION Deputy Attorney General, head of Corporate Fraud Task Force

AGE 56

EDUCATION BA Culver-Stockton College, MA Michigan State University, JD University of Michigan

FAMILY Wife, Brenda, two sons

CAREER HIGHLIGHTS U.S. Attorney in Atlanta 1982-1986; Partner, King & Spalding 1986-2001; Independent Counsel investigating scandals in President Reagan's Housing Dept., 1995-1999

INTERESTS African American art, sports

"Regardless of the credibility that Larry brings, there is going to be enormous pressure on him to show some very tangible results," says Eric H. Holder Jr., Deputy AG in the Clinton Administration.

Bush wants results ASAP. He gave Thompson just 10 days to call the first

meeting of the group, which includes FBI director Robert Mueller III, two Assistants and seven U.S. Attorneys. Thompson's task force will replace an existing task force of career prosecutors who specifically on Enron and Andersen matters. But he will oversee that investigation as well as securities fraud and myriad other probe led by at least 17 Attorneys. These include investigations of Qwest Communications International, Crossing, and Adelphia Communications. Legal experts say one of Thompson's highest priorities will be pursuing individuals responsible for WorldCom's \$3.8 billion accounting malfeasance.

Outside of legal circles, the view is that Thompson has done much on the corporate crime front so far. "The AG has been very aggressive. [But] I haven't heard much from the Justice Dept.," says Pfizer's Henry A. McKinnell.

But Thompson could silence the doubters. Behind his key persona lies a thorough book-at-'em prosecutor. In his decision, for instance, to prosecute Andersen. So his closest friends complain that he caused thousands of innocent Andersen employees to suffer. But Thompson shows little sympathy. "That would be an impermissible consideration," he says unapologetically, "that in any case there are innocent victims, such as the families of those sent to prison."

Such concerns also matter much to a public hungry for some high-profile convictions. Justice sources expect more cases like Andersen, which is indicative of the approach on Thompson's part. A prosecutor who would spend months or years patting a building a case, he now is moving once he has some evidence he thinks will stand up in court.

That's important, because

the new SWAT team must dispel the notion that the wheels of justice are not turning fast enough. If it can't, that will only be bad for Larry Thompson and bad for George W. Bush, too.

By Dan Carney in Washington with Amy Barrett in Philadelphia

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THE GHOSTS THAT WON'T GO AWAY

Exonerated or not, Bush can't easily shake off his past at Harken

There is no question that George W. Bush's second-biggest job as President is to restore faith in Corporate America and make the stock market safe again for investors. But as he wrestles with the demons that bedevil Big Business, he finds himself haunted by ghosts from the past.

More than a decade ago, as director of Harken Energy Corp., Bush engaged in practices that seem similar to those for which he now scolds Corporate America. He was a member of Harken's audit committee, for example, at a time when it prematurely booked income on the sale of a subsidiary and overstated profits, errors that the Securities & Exchange Commission forced Harken to correct. He sold a substantial number of shares just eight days before Harken showed a major loss. And he was chronically late in filing his SEC forms.

Sound familiar? Improper revenue recognition is behind many of the recent accounting disasters. And failure to disclose important information to shareholders is one of the President's biggest complaints about today's "see-no-evil" CEOs. "This is an uncomfortable situation for Bush," says University of Texas political scientist Bruce Buchanan. "Inno-



cently or not, there's a similarity to the Enron style of accounting."

Democrats smell a whiff of hypocrisy. "President Bush likes to preach responsibility," says Democratic National Committee Chairman Terence R. McAuliffe. "But when it comes to [his] own

records, the motto is: 'The buck over there.'" In his defense, Bush the SEC dismissed charges of insider trading years ago. "There's no there," he pronounced in a testy press conference.

The parallels between the current epidemic of audit failures and Harken dealings aren't easy to turn off, though. His problem dates to 1986, when he exchanged his stake in Spectrum 7, a floundering oil company, for \$600,000 worth of Harken shares. Bush not only joined Harken's board but also sat on its audit committee where his job was to oversee the preparation of financial statements by anyone other than Arthur Andersen.

Harken later had problems, too. To raise revenue in June, 1989, it sold a Hawaiian subsidiary, Aloha Petroleum Ltd., to a group of Harken insiders for \$12 million. The buyers paid \$1 million in cash, and Harken took a note for the remainder. Harken then claimed income of \$8 million, even though accounting rules bar recognition of revenue from an IOU unless the noteholder has sub-

tial collateral and the company is "reasonably assured" the loan will be paid. The play was Harken reported a loss of \$3.3 million instead of \$12 million. Less than two months later, Harken sold 212,140 of

BUSH IN 1989
Democrats detect a whiff of hypocrisy when the President explains earlier stock moves

Harken shares at \$4 a share, realizing nearly \$849,000. But Bush's shares probably would not have been valued as highly had Harken reported the larger loss. The SEC later forced Harken to restate its earnings without the bulk of the Aloha sale proceeds.

Bush's second problem is his inability to put to rest questions of whether he had inside information before he

Back in the Oil Patch

APR. 1986 George W. Bush sells his stake in oil drilling outfit Spectrum 7 for \$600,000 worth of Harken Energy shares. Unlike most other officers of companies that Harken acquires, Bush becomes a Harken director and sits on the board audit committee.

JUNE 1989 Harken sells its Aloha Petroleum subsidiary to major Harken stockholders for \$1 million in cash and an \$11 million note. Harken books \$8 million profit on the sale, despite the IOU.

MAR. 30, 1990 Harken reports an '89 loss of \$3.3 million.

JUNE 22, 1990 Bush reaps \$849,000 by selling 212,140 Harken shares at \$4 a share. He previously had filed a Form 144 notifying the SEC of his intention to sell shares.

JUNE 30, 1990 Harken calculates a second-quarter loss of \$23.2 million, eight times the loss in the year-ago quarter. When Harken reveals this in August, share price plummets to \$2.38 but bounces back to \$3 next day.

JAN. 1991 The SEC forces Harken to restate its '89 earnings, thus adding more than \$9 million to a reported loss of \$3.3 million.

MAR. 4, 1991 Bush files Form 144 notifying the SEC of his intention to sell stock as a company insider. Weeks later than SEC rules dictate, campaigning for Texas governor, he blames the late filing on the claiming regulators misplaced the

APR. 1991 The SEC opens an insider trading investigation.

more than two years, the SEC investigated allegations that Bush had shares in June, 1990, knowing that he would report a larger-than-normal loss. Two months after he sold, he reported a second-quarter loss of \$2 million. On the news, its shares fell from \$3 to \$2.38.

Complicating his case, Bush repeatedly failed to file a Form 4, or notice of stock sale by an insider. It wasn't until March, 1991—34 weeks late—that he notified the SEC of his 1990 sale. An internal SEC memo released to the public for Public Integrity, a watchdog group, says Bush was late reporting transactions totaling \$1.02 million. Only for him, the SEC at the time would not prosecute individuals unless they were caught at least six times.

Bush beat the insider-trading rap because his lawyers were able to show he could not have known the size of Harken's second-quarter '90 loss. And since the market took more than two years to react to the loss, an SEC economist concluded that the earnings announcement was not a "material" event. The cloud won't go away.

For one thing, Bush's father was indicted during most of the probe, and SEC chairman, Richard C. Breeden, served as one of his White House advisers. Moreover, the SEC general counsel at the time of the probe was E. Doty, who earlier represented the W. when he bought the Texas Rangers ball club. Most of the funds raised in that deal came from his own share sale. Doty, however, says he distanced himself from the inquiry.

All much ado about nothing, Bush says: "In the corporate world, some things aren't exactly black and white when it comes to accounting procedures." Unfortunately for the President, he says that sort of explanation isn't to quiet the critics.

By Paula Dwyer in Washington

Internal SEC memo notes he failed to file on time.

The SEC closes the probe, based on an Enforcement Div. report, despite his audit committee didn't have early notice of most information in Harken's second-quarter report when he sold stock.

2002 The White House says Bush misspoke when he told the SEC for his late forms. Bush now says the delay was due to a "mistake" by lawyers.



CHENEY: Under SEC scrutiny

Numbers Games?

OCT. 1995 Dick Cheney named CEO of Halliburton.

JAN. 1999 Halliburton changes accounting to record projected reimbursement of \$89 million for cost overruns as income for 1998. Halliburton does not disclose the change until March, 2000.

AUG. 2000 Cheney resigns from Halliburton to join George W. Bush on the GOP ticket. He is sworn in as Vice-President the following January.

MAY 2002 *The New York Times* reports that the accounting change boosted Halliburton revenues by \$234 million over four years. SEC launches investigation.

JUNE 2002 SEC Chairman Harvey Pitt says Cheney is "not immune" to the agency's probe.

THE CHENEY QUESTION

Will the Halliburton probe turn the Veep into a White House liability?

For two years, Vice-President Dick Cheney has been President George W. Bush's No. 1 asset. The former Defense Secretary and corporate CEO has provided the Washington and diplomatic experience Bush lacked. But as the Administration's focus swings from a war on terror to a battle against corporate greed, Cheney risks becoming a political liability to his boss. The problem dates back to an obscure 1998 change in accounting policies at Halliburton Co., the Dallas-based energy services-and-construction giant Cheney headed from 1995 until 2000.

The Securities & Exchange Commission is investigating whether Halliburton pumped up revenues by \$234 million over four years. Cheney has spurned all questions, while Halliburton execs are scrambling to stress that the Veep

wasn't involved in the change. That's in stark contrast with Bush's calls for CEOs to shoulder personal responsibility for financial practices—as Democrats are quick to note. Turning up the heat, the watchdog group Judicial Watch on July 10 sued Cheney for allegedly fraudulent practices at the company he once headed. Both the White House and Halliburton say the suit is completely without merit. Nonetheless, frets a GOP strategist, Cheney's predicament "could linger like a low-grade fever."

Despite all the political flak Cheney is taking, Halliburton's shift may actually have improved its bookkeeping. But the timing raises questions: Without the change, Halliburton's already depressed 1998 profits would have fallen far short of Wall Street's targets. And the SEC can't overlook the delay of more than a year before Halliburton told investors that its accounting had changed.

At issue is how Halliburton accounts for cost overruns and changes on its billion-dollar contracts to build such projects as offshore drilling platforms or liquid natural-gas plants. Until 1998, the company wouldn't report revenue from such claims until the customer agreed to pay—which could take years. But since 1998, Halliburton has estimated how much of the disputed costs it expects to collect and booked the not-yet-received payment immediately. For 1998, Halliburton booked \$89 million in

pretax revenue as unpaid claims. Similar claims added \$43 million to revenue in 1999 and \$102 million in 2001; there was no impact in 2000.

While it's aggressive, Halliburton's switch is supported by a 1981 accounting rule because it helps meet accountants' goal of matching revenues with associated costs as they occur, says Douglas R. Carmichael, an accounting professor at Baruch College. Ten of the 15 largest construction companies use the method Halliburton adopted in 1998, says Halliburton CFO Douglas L. Foshee.

Halliburton must prove to the SEC that its collection estimates were reasonable. "If it looks like they were just fabricating the numbers, that verges on fraud," says J. Edward Ketz, professor of accounting at Penn State University. Foshee says the company has an "extremely sophisticated model" for estimates and that projections were sound.

Even if the accounting change passes muster, the timing may raise red flags. In 1998, Halliburton was digesting its takeover of rival Dresser Industries, and profits were down. Without the change, earnings would have fallen far short of expectations. Foshee concedes that the added revenue contributed \$55 million to the year's \$730 million in after-tax profits. But he insists the change was made in 1998 because Halliburton decided in 1997 to focus on bigger, fixed-price jobs, on which the company must negotiate cost overruns. Yet some critics, including former Halliburton execs, argue that most contracts were already fixed-price. And the company says it doesn't disclose its contract mix.

More troubling: Halliburton didn't disclose the switch to the SEC or investors for more than a year, until March, 2000. Halliburton says the change wasn't big enough to matter, since sales in '98 were \$17 billion, dwarfing the \$89 million boost from the accounting switch. But the SEC may focus on the bottom-line impact and rule that it did matter. With the agency forcing companies to spell out their accounting policies, Halliburton could draw a fine for its delay.

Cheney probably won't be held personally responsible—but that's little relief for nervous White House aides. Unlike Bush's long-ago woes at Harken Energy Corp., Cheney's Halliburton days are still under investigation. Even if the SEC exonerates the Veep, Cheney's stonewalling won't do much to help the credibility of Bush's call for corporate responsibility.

By Mike McNamee in Washington and Stephanie Anderson Forest in Dallas



CASHING OUT LIKE CRAZY

Mutual-fund investors are fleeing like there's no tomorrow

By 8:20 a.m. on July 9, Jill Bell was already calling her broker. She had just one word for him: Sell. "I've lost a nice little piece of change, and I don't want to lose any more," says the 57-year-old executive assistant from Atlanta. After studying her second-quarter mutual fund statements, her mind was made up: "I'd rather make no money at all than keep losing 5% of it every three months."

Bell has a lot of company. Increasing numbers of investors are throwing in the towel on their U.S. stock funds, battered by rising mistrust of Corporate America and mounting portfolio losses. In the five weeks through July 5, U.S. equity funds bled nearly as much money as they did in the weeks after September 11. In June, outflows totaled an estimated \$20 billion vs. inflows of \$4.8 billion in May, according to TrimTabs.com Investment Research Inc. And the trend is accelerating: Banc of America Securities Chief Investment Strategist Thomas McManus estimates that during the four-day holi-

day week ended July 2, another \$-lion headed out the door.

True, even with the recent e investors have put a net \$52 billion mutual funds this year through slightly more than in the same last year. Yet they turned decidedly pessimistic as second quarter losses of by the average U.S. stock swamped minuscule first-quarter. What's worse, the latest quarter that the three years through June produced an annualized loss of a 4.2%—the first time in a generation the average stock fund has shown negative returns over a three-year period.

Paradoxically, the flight from the market by ordinary investors is a heading sign to the pros. "When people saying forget about it, I want nothing

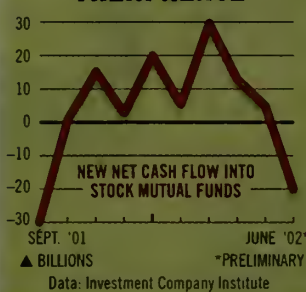
do with my equity mutual fund, that's usually a good sign that things are washing out," says G. Belski, market strategist with U.S. Banc Piper Jaffray. Exactly the reverse happened in the first half of 2000, as investors giddily piled into a record \$182 billion of mutual funds at the market's peak.

To be sure, sentiment polls and technical

cators have failed miserably to predict bottom in this post-tech-bubble market. Though it seems like twisted logic, may well be that as more investors lose hope, the nearer the market is to a bottom. Ultimately, investors will be able to climb the wall of worry only when they see a solid rebound in corporate earnings that they can trust.

By Mara Der Hovanesian in New

INVESTORS LOSE THEIR NERVE



COMMENTARY

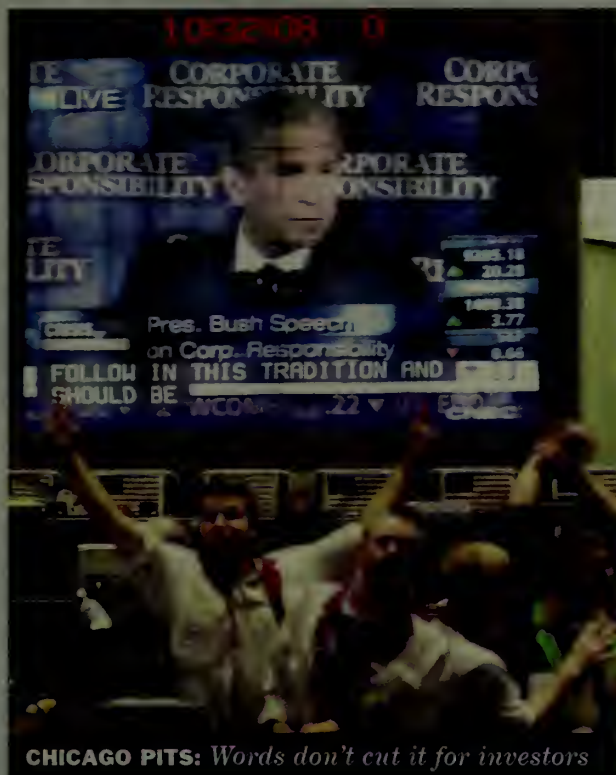
By Marcia Vickers

NICE SPEECH, MR. PRESIDENT, BUT ...

the Big Guy spoke, and the market has been sinking like an anchor in a fishpond. Although President George W. Bush's July 10 speech was designed to restore confidence, major stock indexes tied their free fall. Now, both the Nasdaq Composite Index and the Standard & Poor's 500-stock index crashed through their depressed September 11 levels to hit five-year lows. The next day, the Dow Industrial average plummeted more than 3%.

Why, Mr. President, even after the speech, investors still aren't confident. In fact, the term "confidence" doesn't apply in the current climate—investors are mad as hornets. Truth is, the grand pooh-bah himself can't put a quick end to the sour mood of investors or their mistrust. "We really need concrete examples from CEOs that they're not tone deaf to what's going on, along with real changes in policies that address compensation and accounting," says Richard E. Linn, chief equity strategist at Legg Mason. Also, many investors say that the president isn't going far enough. "I'm afraid if he pushes for too many reforms, he'll spook the stock market further. But he's spooking it by not pushing for meaningful, quick action," says New York Attorney General Eliot Spitzer, who has been pressing for concrete rules to tame analysts.

Even so, Bush's requirement that chief financial officers must report for their companies' annual financial reports by Aug. 14—and be personally accountable for the numbers—will be a good start. "CEOs need to get their act in a row, so they're going to move forward and be more proactive when it comes to earnings," says L. Hill, managing director at Morgan Stanley research



CHICAGO PITS: Words don't cut it for investors

firm Thomson Financial/First Call.

Indeed, if companies come clean about their accounting practices and stop managing earnings, stocks may suffer a prolonged drag. According to several strategists and economists, companies have been overstating earnings by as much as 15% annually over the past five years. The New Economy "was, in the end, mostly hype," says Robert J. Barbera, chief economist at Hoenig & Co. Adds a prominent hedge-fund manager: "It's not possible for companies to meet the numbers they've been reporting without the aid of accounting tricks, especially in a recession."

The stock market is almost certain to become more volatile and risky as new negative surprises and restatements of earnings roil investors. "I call this the Year of Final Purge & Healing. It could take months for all of this to shake out," says Charles Pradilla, chief invest-

ment strategist at SG Cowen Securities Corp. Once that has happened, the market would be on a more solid footing as stocks become realistically valued.

Meantime, investors have been parking cash on the sidelines and pouring equity into their homes and other hard assets such as gold. No wonder. They were still reeling over Enron and Tyco International when a whole host of other companies were brought into question, including Qwest Communications, WorldCom, and Merck. And foreign investors, who hold \$5 trillion in American securities, have become much less enthusiastic. According to a report recently issued by Banc of America

Securities, foreign purchases of U.S. stocks are off to a much slower start than they were in previous years.

Even so, the news isn't all bad. The economy continues to gain ground. Earnings of S&P 500 companies are expected to rise 3% this quarter from a year ago, 17% in the third quarter, and 28% in the fourth, according to First Call. "The recovery is real, and we're in an important cyclical rebound for earnings," says Hoenig's Barbera. However, investors won't act on those numbers until they actually see them—anticipation of improving profits, always a big market driver in the past, is no longer enough. Says Edward M. Kerschner, UBS/PaineWebber's chief global strategist: "If you don't know whether to believe those numbers, do you believe they will turn up?"

Bottom line: A soothing speech, a treasure trove of good ideas, a solid game plan to preserve financial integrity are all a good start. But, Mr. President, only an improving economy coupled with a strengthening profit picture will send this troubled market into bull territory.

With David Henry in New York



FRANTICALLY PADDLING TO KEEP WORLDCOM AFLOAT

CEO Sidgmore has a rescue plan, but it's a long shot

To most anyone outside of its offices, WorldCom Inc. looks like a company that has lost control of its future. When it admitted in late June that it had misaccounted for nearly \$4 billion in expenses, it sparked outrage across the country and helped provoke President George W. Bush to call for a crackdown on corporate criminals. Bernard J. Ebbers and Scott D. Sullivan, the company's former CEO and chief financial officer, respectively, were hauled before a congressional committee and publicly berated. Meantime, the company seems to be hurtling toward bankruptcy, with \$32 billion in debt it can't pay and a stock price that's cheaper than a can of soda pop. Add it all up, and most telecom experts say WorldCom is going to have to sell off all of its assets and close its doors.

Just don't tell that to John Sidgmore. The company's new CEO is determined to save WorldCom, albeit as a smaller company. He wants to sell off a handful of assets to give creditors some cash and then persuade them to trade their debt for equity in a new, leaner WorldCom—with him at the helm. The company would focus on selling voice, data, and Internet services to business customers. At its core would be UUNET, the company that carries more than 50% of America's Internet traffic and counts among its customers the Nas-

daq stock exchange and the U.S. military. In a sense, Sidgmore is trying to return to his roots—he took UUNET public in 1995 and ran it before WorldCom acquired it. "We'll sell off noncore assets and refocus ourselves," says Sidgmore. "We'll be stronger if we can trim ourselves down to a leaner, simpler-to-understand organization."

Sidgmore is peddling several assets that could raise up to \$4 billion. They include the company's wireless business and the Skytel Communications Inc. paging business, which is valued at about \$1 billion. He also would like to sell the MCI Group long-distance business, which is worth about \$2 billion, but there are no takers so far because of the debt and other conditions WorldCom insists on in such a sale.

Will creditors go for Sidgmore's plan? It will be tough getting all the parties to agree. But Sidgmore does have a small chance of pulling it off. Many bondholders agree with his argument that they will get more from taking eq-

uity in the new WorldCom than force a liquidation at today's prices. UUNET, after all, is expected to increase revenues 20% per year, to \$1 billion in 2003. "There is enormous potential there," says Matthew Bridge, vice-president at DebtTrade, a high-yield investment firm that is buying WorldCom debt. Adds a lawyer representing another bondholder: "WorldCom would be a fabulous company cleaned up its balance sheet."

Banks may go along with this plan, but at a high price. They're now offering \$2.65 billion, compared with the \$3 billion due bondholders. Deutsche Bank, J.P. Morgan Chase & Co., and several other banks are offering to loan



SIDGMORE: Pushing sales and debt-for-equity swap

more \$3 billion in cash to keep WorldCom going, but only if they are repaid their \$2.65 billion immediately and a new loan is secured by the company's assets. "That, of course, would piss off the bondholders," says Sidgmore. "It's a balancing act, with me trying to get the right offer that will get bondholders and the banks on board."

Sidgmore may very well take a beating in the weeks ahead. Creditors are demanding his ouster if he is implicated in the company's accounting scandal. He's facing a cash crunch because business customers are skittish about WorldCom's financial health and are delaying payments. Suppliers are demanding cash in front for equipment and other goods. If WorldCom doesn't get the new financing from the banks or elsewhere by September, the company likely will run out of cash. "Sidgmore has a very difficult task in keeping the company intact," says Blair Levin, a telecom analyst at Legg Mason Inc. Still, he's determined not to turn his back on his roots.

By Charles Haddad in Atlanta, Steve Rosenbush in New York

Back to Basics?

CEO Sidgmore wants to refocus Worldcom around his original company, UUNET, which provides corporations with Internet access and data services

PROS

- UUNET remains the leading Internet pipeline, handling over 50% of U.S. online traffic.
- The company retains a blue-chip roster of customers, including AOL Time Warner, FedEx, and Nasdaq.
- By selling WorldCom's paging, wireless, and long-distance businesses, Sidgmore could raise up to \$4 billion.

CONS

- Internet access and data prices have collapsed, falling 92% from February to May.
- WorldCom faces a cash crunch. If it doesn't get fresh financing by September, Sidgmore may run out of time.
- WorldCom's businesses could fare better as part of a regional telephone operator.



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MILEAGE BALANCE
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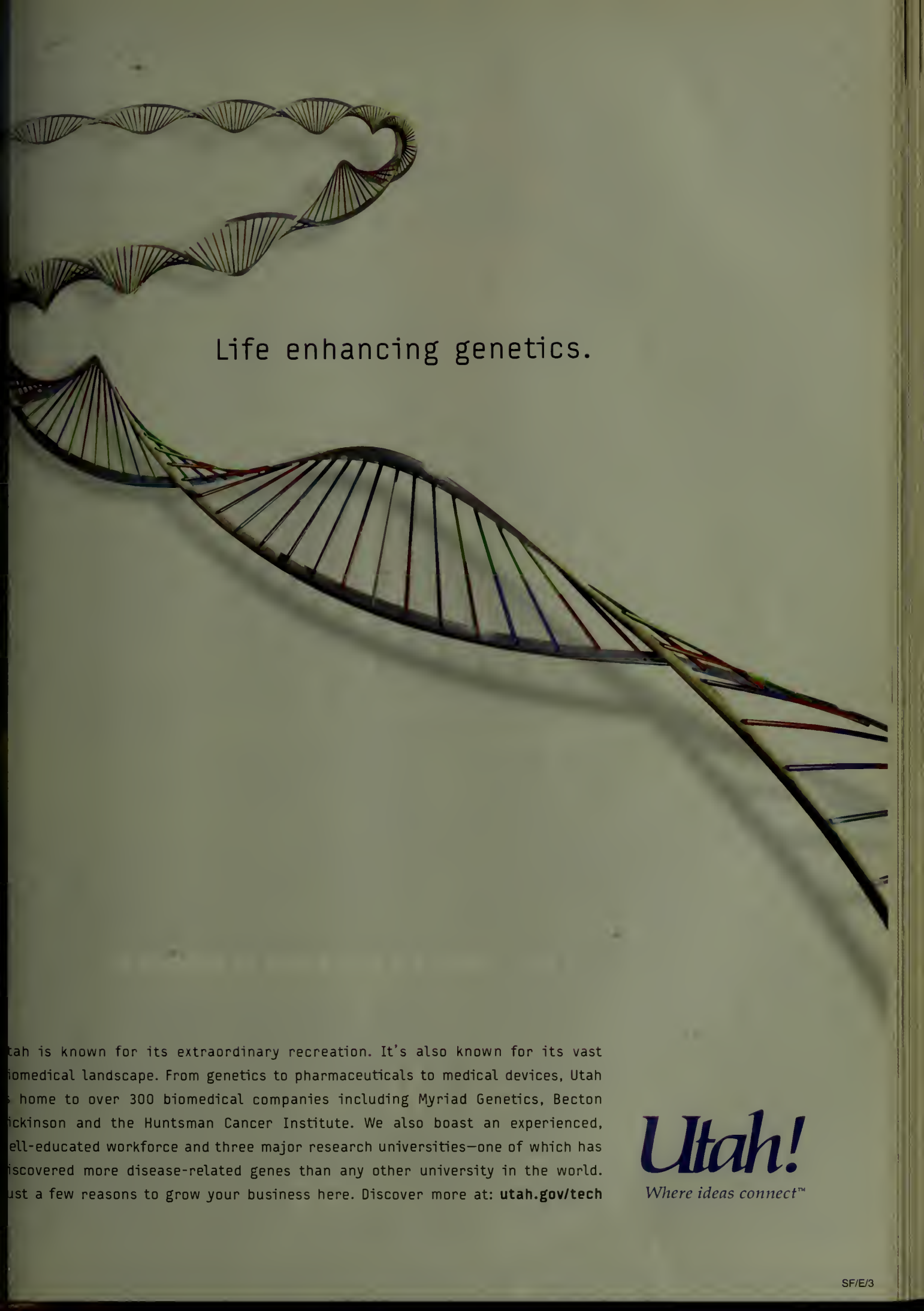
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ECONOMY

RECOVERY? MANUFACTURERS AREN'T CONVINCED

They're not hiring or spending despite an uptick in orders

Near the optimists tell it, the battered manufacturing industry is finally on the mend. Orders are up, production is climbing. After leading the U.S. into recession last year, manufacturers are ready to propel the economy back to the promised land of sustained growth.

But don't sound the trumpets just yet, though. True, manufacturing has rebounded from last year's low, but the recovery remains weak and uneven. While basic industries as steel and autos are increasing output, others, such as telecom and aerospace, remain depressed. What's behind the manufacturing rebound, as it is, has yet to translate into stepped-up hiring and increased capital outlays that every economist concedes is necessary for full-fledged expansion. Although it's now only 17% of the economy, manufacturing is still lagging because it's the swing factor, rising and falling while the rest of the sector remains relatively

flat. Through the first five months of this year, industrial production has risen by a half-percent per month—less than half the typical pace of past recoveries. And as measured by the Federal Reserve, production is still below the level that prevailed before September 2001, its hardly cause for celebration. It's sobering, in some industries, such as technology and telecommunications—sectors that drove economic growth during the 1990s—there's little sign of much of a recovery. On July 1, Advanced Micro Devices Inc., the world's second-biggest maker of PC processors, said second-quarter sales were \$600 million—below the \$620 million projected two years earlier. Blame it on fizzling PC demand following an end-of-year slump. And even in areas where demand is pick-

ing up, manufacturers can't seem to get a break. That's due in part to a glut in manufacturing capacity that is forcing many producers to cut prices to keep going. Alcoa Inc., the world's largest aluminum producer, reported on July 8 that its second-quarter profits fell by



nearly 25%, to \$232 million, as falling prices canceled out a rise in shipments.

It's no wonder, then, that manufacturing companies remain cautious and are keeping a tight rein on hiring and spending. Even as industrial production has picked up this year, manufacturers have continued to hack away at their payrolls, reducing them overall by nearly 200,000, including 23,000 jobs eliminated in June.

Instead of taking on more workers, companies are asking existing employees to work more hours or are hiring lower-cost temps. But even there, executives are moving cautiously. According to Manpower Inc. CEO Jeffrey A. Joerres, manufacturers are taking on temporary workers for 30- to 60-day assignments rather than indefinitely, as they did in the past.

When it comes to capital outlays, manufacturers are even more tight-fisted. A survey released July 10 by the National Association for Business Economics found that goods-producing companies slashed capital spending again in the second quarter—the sixth straight quarter that has happened. High-tech firms have been particularly brutal, with hard-pressed chipmakers expected to slash investment by 20% this year, according to Morgan Stanley analyst Steven Pelayo.

Yet all is not gloom on the factory floor. Auto sales have stayed strong, though Detroit has had to offer stepped-up incentives to entice buyers into

BRIGHT SPOT Incentives have helped auto sales retain their strength

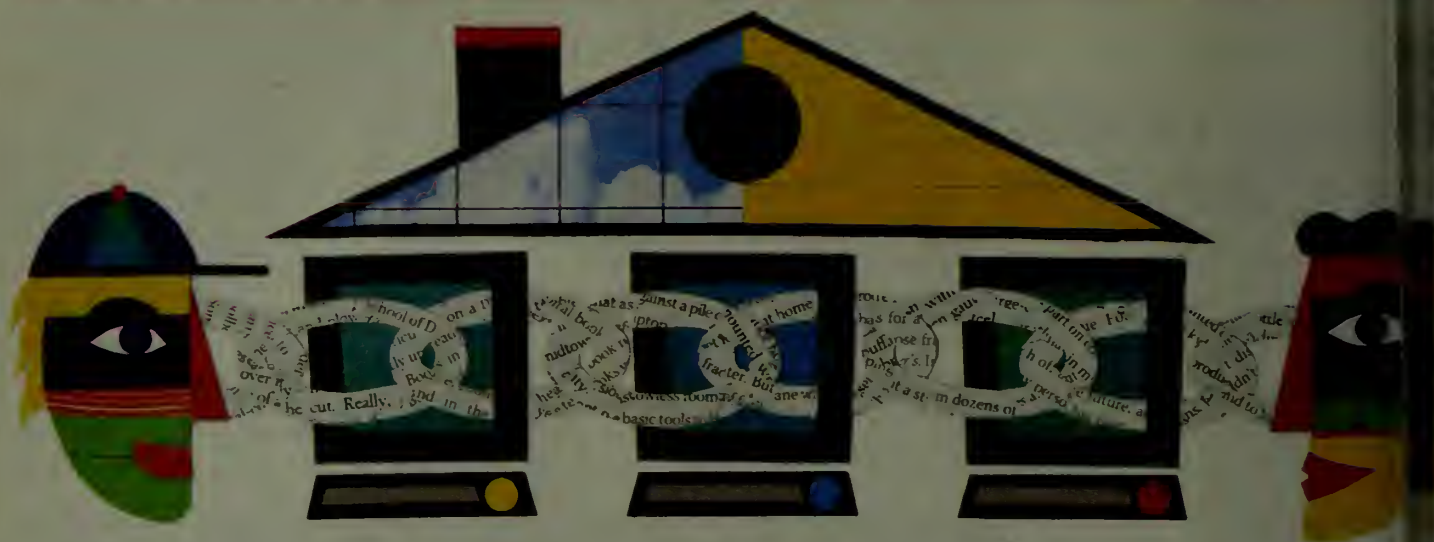
showrooms. Honda Motor Co. is gearing up, announcing on July 9 a \$466 million expansion at three of its North American plants. "We feel the market is gradually expanding," says Thomas G. Elliott, executive vice-president at American Honda Motor Co.

Other manufacturers aren't so sure, even with demand for their products rising. "While we are seeing improvements in several important sectors," says Raj L. Gupta, CEO of Rohm & Haas Co., a Philadelphia chemical maker, "we see no reason at this time to assume that demand will continue at this rate." His bleak assessment sums up the prevailing sentiment in Factoryland USA these days. Despite what the optimists say, the economy may still have a long, hard slog ahead.

By Rich Miller in Washington, with bureau reports

BUT WILL IT LAST?





Microsoft Corp., whose software has come to dominate the workplace, now wants to take over your living room as well. Last October, the Redmond (Wash.)-based software giant launched Windows XP, the new operating system that makes it a snap to organize music files and gather digital photos. Microsoft then jumped into the video gaming market, with its Xbox game console. And on July 11, it plans yet another bold foray, this time into home networking.

With global sales last year of \$1.4 billion, home networking hardly holds the sex appeal—or the profitability—of the lucrative game console business. But Microsoft now believes that networking devices, known as routers, may be the key to controlling the digitally wired home. By selling routers that link PCs to game consoles, TVs, and other household devices, Microsoft is hoping to serve as the gatekeeper connecting consumers to the multibillion-dollar world of digital entertainment: games, movies, music, and other services. At the same time, Microsoft hopes to defend its place as the technology centerpiece for consumers against intrusions by other home-networking services. “There’s a bigger strategic connection,” acknowledges Adam LeVasseur, a group product manager at Microsoft.

In Microsoft’s vision of the future, all these home devices and appliances will be connected through the router not just to one another, but also to the Internet. Thus, rock fans could download the latest tunes from a Net service and then access the song on their stereo. And families could share a high-speed Net connection so teens could swap instant messages with their pals at the same time Mom pays bills online.

For its part, Microsoft won’t discuss

COMPUTING

THE HOUSE THAT MICROSOFT IS BUILDING

A plan to sell routers is key to its vision of the digital home

details of its networking plans, except to say it will offer kits for both wired and wireless connections. And while it hasn’t announced pricing, analysts briefed by Microsoft expect the giant to match competitors like Linksys Group Inc. and Netgear Inc.—charging roughly \$250 for a wireless broadband router—and perhaps then bundle it with deals on its high-speed MSN Internet service. “Competitors should be worried,” warns Mike Wolf, an analyst with industry researcher In-Stat/MDR.

Microsoft’s networking rivals may lack the clout to fight back. Linksys and Netgear, the current leaders in home-networking devices, combined for less

than \$600 million in sales last year, mere 2% of Microsoft’s revenues the same period.

Ironically, both companies work closely with Microsoft to ensure its Windows XP worked well with networking gear. Now, they face the prospect of competing with the company that provides the technology data to make their products operate seamlessly with Windows. “Potentially there’s a conflict of interest,” Linksys Vice-President Janie Tsao nonetheless hopes to stay a step ahead of Microsoft in innovation.

History suggests that they should be wary. Last year, a federal appeals court upheld a lower court ruling that Microsoft illegally added features to Windows to put its chief browser rival, Netscape Communications Corp., at a disadvantage. Microsoft’s networking rival is keenly aware of its record. “You know they will behave as they have been in the past,” says Netgear Chief Executive Patrick C.S. Lo.

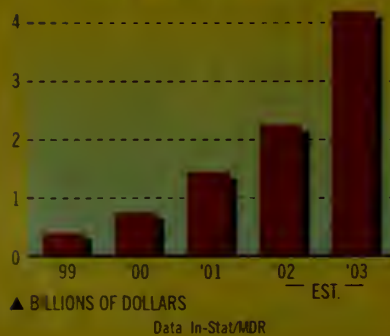
Still, home networking is far from a sure bet for Microsoft. The software giant has dabbled before in hardware with mixed results: Its keyboard mice are best-sellers, but its efforts to sell PC speakers and PC-connected cell phones in the late 1990s fizzled after only a year. And while Microsoft’s Xbox game console has sold well domestically, the weak response overseas has led the company to slash its Xbox sales projections by as much as 40% for the period ended June 30.

How big will the home-networking business be for Microsoft? Some analysts believe the market could more than double over the next few years, to \$1 billion or more. However fast the market grows, you can bet Microsoft will be there angling for the lion’s share.

By Jay Greene in Seattle

GETTING WIRED

GLOBAL HOME NETWORKING SALES



EVERYONE LOVES A FREEBIE—EXCEPT DELL'S RIVALS

company's prizes to buyers may ignite a deadly price war

Free digital cameras and printers. Big rebates. Daily sweepstakes. Computer makers are falling over themselves to get people to buy their PCs, offering incentives even as PC prices plumb new lows. Why the panic? The likes of Compaq, Hewlett-Packard, Gateway, and Apple overestimated demand for their products. Up to 100 unsold PCs are gathering dust on shelves and in warehouses, estimates IDC analyst Roger Kay. "The air of desperation is in the air," says researcher Toni Duboise at PC product-firm ARS Inc.

At least one PC maker smells opportunity. In an effort to boost already formidable 28.4% market share, Dell Computer Corp. is offering customers the chance to win \$50,000. During July, customers who buy a Dell PC are automatically entered in a daily sweepstakes. The move—unprecedented in the industry—could help the No. 2 maker increase sales of consumer machines, which are expected to account for some 20% of the company's projected \$8.2 billion in second-quarter revenue.

Better yet, Dell says, the promotion will undercut rivals' efforts to clear inventory backlogs. That will give Dell the one thing many fear will hurt: a dismal back-to-school season. Under its Internet-selling model, Dell keeps only a few days' inventory on hand. Meanwhile, Hewlett-Packard Corp. had 11 weeks of inventory piled up in June—nearly four times the industry average. European sales of Apple Computer Inc.'s new iMac have taken a turn for the worse.

Dell has little to lose. In market share reports due July 15, research companies IDC and Gartner

Dataquest are expected to show Dell making continued gains worldwide. That's despite HP's recent takeover of Compaq Computer and Gateway's price-cutting strategies. Dell says it will turn a second-quarter profit, even as rivals lose money. And the sweepstakes' promotion cost only \$1.55 million plus administrative expenses, says Dell Marketing Director Erin Nelson, who adds that initial interest in the giveaways has met expectations.

Other PC makers are frantically trying to match Dell's promotion. Apple is offering no-payment financing through October. Gateway Inc. is giving away

a free printer or scanner with certain PCs. And HP is offering its own sweepstakes—three \$2,000 shopping sprees—and rebates of up to \$725. Even as they roll out their own incentives, there is a sense in the industry that Dell isn't playing fair with its sweepstakes. "We offer rebates to all customers, as opposed to the Dell approach that focuses on the lucky winner," says HP spokesman David Albritton.

It's by no means certain that all the giveaways and rebates will work. After all, even fire-sale prices have done little to entice reluctant buyers. Consumers see little reason to upgrade computers as often as in the past. And many corporate customers have yet to replace aging systems. Brokerage Merrill Lynch & Co. now predicts PC sales will rise a measly 2.5% this year, to 132 million units worldwide, down sharply from its earlier projection of a 10.5% year-over-year unit gain. Worse, average prices are expected to decline 9%.

And PC makers clearly realize that incentives alone won't suffice. In the continuing wait for an industry recovery, some are looking elsewhere to shore up the balance sheet. HP is undertaking a major revamp of its profitable printer business and this fall plans to launch dozens of models aimed at further boosting margins. Meantime, Apple is considering releasing a Windows version of its hot-selling iPod digital music player, perhaps as early as the July 17 opening of the Macworld Conference & Expo in New York. Even Dell is considering some changes, including launching its own line of printers. The move could further hurt HP and bring in millions of additional profits from ink sales.

Of course, that still leaves computer makers with the problem of what to do with their rising inventories. With researchers now slashing their estimates for growth in 2003, Dell's sweepstakes' offer could be just the first shot in a battle that will get uglier and uglier. That's good news for consumers now. Down the road, though, another round of industry bloodletting could mean fewer PC makers to choose from.

By Cliff Edwards in San Mateo, Calif.



DESPERATE MEASURES?

Amid lackluster PC sales, incentives are the order of the day

- ▶ Dell is giving away \$50,000 a day in a monthlong sweepstakes and throwing in a digital camera with each PC
- ▶ Apple is wooing buyers with a financing plan that includes no payments until November
- ▶ Hewlett-Packard is dangling \$400 rebates on Compaq and HP brand PCs
- ▶ Circuit City, Best Buy, and CompUSA offer rebates and savings plans

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EDITED BY ROBIN AJELLO

QWEST: ANOTHER UNDER A CLOUD

ANOTHER BIG JOLT FOR THE beleaguered stock market: Qwest Communications International confirmed it is the subject of a criminal probe. Neither Qwest nor the U.S. Attorney's Office in Denver would elaborate on the investigation. The company has previously acknowledged that its accounting is the subject of an investigation by the Securities & Exchange Commission. The latest news caused the stock of the struggling Denver-based telecom company to lose more than a third of its value on July 10 and helped prompt a wide-ranging sell-off.

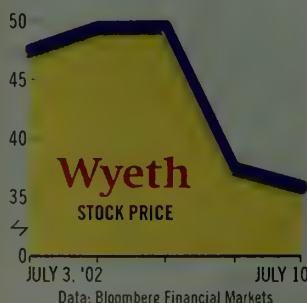
MASTHEAD CHANGE AT HARVARD REVIEW

MANAGEMENT INTRIGUE NEVER seems to end at the supposed Bible of good management, the *Harvard Business Review*.

CLOSING BELL

HEALTH SCARE

Wyeth shares fell 24% to \$37.30 on July 9 after a much-anticipated study revealed that its hormone-replacement therapy product Prempro raised the risk of breast cancer and heart disease. Analysts expect the news will cause many women to avoid it, eroding sales of a \$2 billion franchise at Wyeth and clipping earnings growth.



On July 8, Publisher Penelope Abernathy abruptly quit. Her employers say her Group Publisher job was eliminated as part of a restructuring. But insiders say Abernathy is being punished for recommending an aggressive response to a scandal earlier this year surrounding an affair between former *Review* editor Suzy Wetlaufer and former General Electric Chairman Jack Welch. Wetlaufer, who was writing a story about Welch, quit in April. Harvard Business School Publishing's new CEO, David Wan, insists "the Wetlaufer issue had nothing to do with the way I wanted to organize the company."

S&P GOES ALL-AMERICAN

STANDARD & POOR'S SAID IT will remove all seven non-U.S. companies from the large-cap S&P 500, the world's most widely benchmarked index, at the end of trading on July 19. It will replace them with seven U.S. corporations. On the out list: Royal Dutch/Shell, Unilever, Nortel, Alcan, Inco, Barrick Gold, and Placer Dome. S&P said foreign companies often cause tracking errors between the index and the markets they intend to track. Also, higher transaction fees in foreign markets make it more expensive for investors to follow the index. The newcomers are UPS, Goldman Sachs, Prudential, Principal Financial, as well as three tech companies—SunGard Data, Electronic Arts, and eBay. S&P, like *BusinessWeek*, is owned by McGraw-Hill.

A BUFFETT BLESSING ON TELECOM

HAS THE TELECOM INDUSTRY bottomed out? That's what investors were asking when legendary moment-picker Warren Buffett announced a

HEADLINER: RAYMOND GILMARTIN

TIME FOR A MIRACLE DRUG

The bad news keeps coming for Merck Chairman and CEO Raymond Gilmartin. On July 9, Merck was forced to delay for a third time the initial public offering of its pharmacy benefits arm, Medco Health Solutions. The deal to sell nearly 20% of Medco to the public, postponed indefinitely, received a cool reception, due in part to concerns over Medco's aggressive accounting policies. The company included billions of dollars in copayments by consumers as revenue even though the payments went directly to pharmacies. Merck

has said the policy had impact on earnings and complied with generally accepted accounting principles.



Gilmartin, 61, has other headaches. Patents are expiring on some big drugs. And the new product pipeline remains weak, investors say. "The company has underinvested in research and development," says Lloyd Kopp, a health-care analyst at money manager Harris, Bretall Sullivan & Smith, a Merck shareholder. In spite of the problems, though, Merck says it plans to spin off Medco.

Amy Berman

big bet on Level 3 Communications July 3. Buffett's Berkshire Hathaway joined Level 3's No. 2 shareholder, Legg Mason Funds Management, and Longleaf Partners Funds to invest \$500 million in the company. Buffett had professed an aversion to all things telecom. But in this case, he said in a statement: "Level 3 is well equipped to seize important opportunities." The stock surged 62%, to \$4.70, in the three days following the announcement.

YOU CAN SHELTER, BUT YOU CAN'T HIDE

THE IRS HAS SUED ACCOUNTING firms BDO Seidman and KPMG to force them to disclose information about tax shelters sold to clients. The Internal Revenue Service says promoters of shelters are required to disclose information about both the schemes and the clients who buy them. The

firms insist that the information is confidential. Over the past year, the IRS has requested information on shelter arrangements from different promoters. In June, PricewaterhouseCoopers agreed to pay an undisclosed fine and hand over documents.

ET CETERA...

- AT&T shareholders on July 10 gave their blessing to a proposed merger of its Broadband cable operation with Comcast.
- eBay announced it will acquire Internet payment processor PayPal for \$1.5 billion. The deal is expected to make eBay's online transactions more seamless.
- Shares of bankrupt Kmart Corp. could be delisted from the New York Stock Exchange within six months if the average price stays below \$1, the company says.

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rethink
regroup
reveal

Redefine your power
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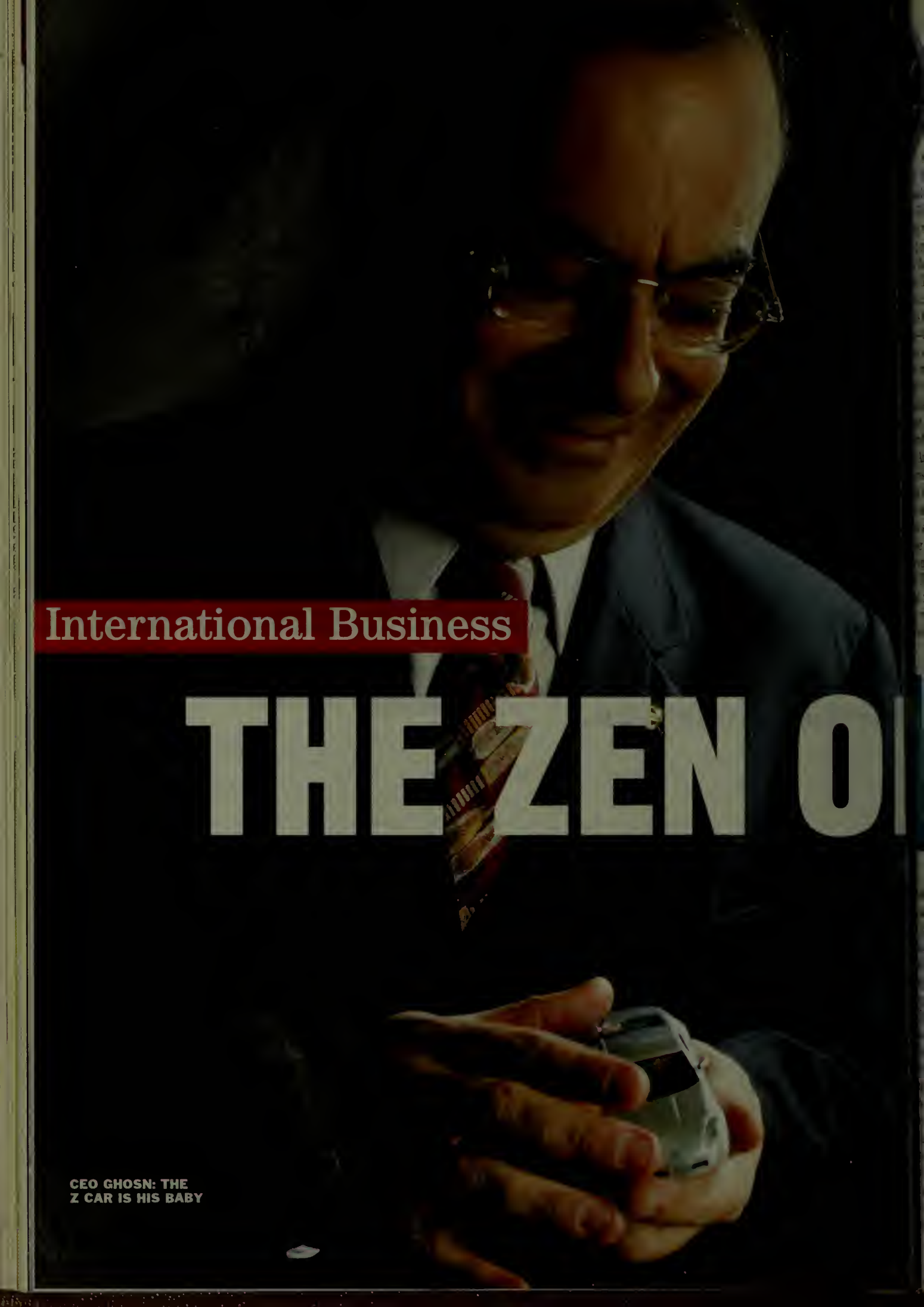
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International Business

THE ZEN OF

CEO GHOSN: THE
Z CAR IS HIS BABY

Six months after being dispatched by his bosses at Renault to overhaul Nissan Motor Co. in 1999, Carlos Ghosn had lunch with an esteemed visitor in the company's 16th-floor executive dining room at its Tokyo headquarters. His guest was the former head of Nissan's U.S. sales subsidiary, Yutaka Katayama, father of Nissan's original 240Z sports car.

Known as "Mr. K," Katayama pleaded a case that had been coldly rejected by Ghosn's Japanese predecessors: revitalizing the Z car line.

The Z-maniacs who still inhabit every corner of the U.S. and Japan—and who, to their friends and families crazy with Z fan clubs, their obsessive search for parts for vintage models, their week-long pilgrimages—this lunch was a high moment in the story of the automobile. Anyone born before 1965 won't get it, but for 15 years—from 1970 to 1985—the Z sports car was the ultimate thrill machine, an unbeatable combination of rakish lines, raw horsepower, and affordability that young Japanese and American guys found impossible to resist. To this day, middle-aged men who can't remember the name of the girl they took to the prom can still tell you everything about their first 240Z. The inline six-cylinder engine. The 150-horsepower. The long nose of the hood. That first sweet moment on the road when the Z opened up and showed what it could do.

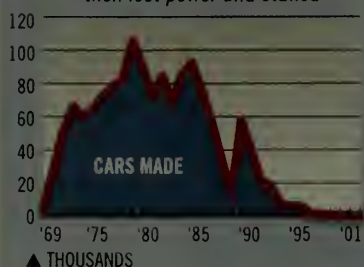
Cost-Killer was a Z-man, too. When he worked for tiremaker Michelin in the U.S. in 1989-96, he often took a company-owned Nissan 300ZX for a spin in the mountains near its North American headquarters in Greenville, S.C.

Now the boss has something else to tool around in. On July 5, the all new 350Zs started to roll off the assembly line at the Nissan plant in Oppama, Japan. Ghosn himself got the first 350Z produced, a silver 3.5-liter V6 model with burnt-orange leather seats, a 240-watt seven-speaker Bose stereo system, and Nissan's own Carwings navigation and infotainment system.

Ghosn's decision could be a milestone for Nissan. Although the company has climbed back from the brink of insolvency in the late 1990s, historically Nissan's fortunes have ebbed and flowed roughly in sync with the popularity of its Z cars. The high performance and dashing design of the Z created a halo effect for the rest of the Nissan line, even back in the days when the company was known as Datsun in the U.S. In their heyday in the late 1970s and early '80s, Nissan and

ZOOM, ZOOM—BUST

The Z roared out of the starting gate, then lost power and stalled



Data: Nissan Motor Co.



350Z

NISSAN

The classic Z car is back. Can it rev up a tired brand?

At the time the 89-year-old Katayama sat down to lunch with the no-nonsense Ghosn, the Z seemed headed for extinction. Production had slowed to a trickle as the company attempted to stave off bankruptcy. U.S. sales ceased in 1994. The arrival of Ghosn, whose reputation for downsizing at Nissan-parent Renault had earned him the name "Le Cost-Killer," seemed to guarantee that the Z would be very, very dead.

The unsentimental Ghosn, however, had a surprising answer for Katayama. "When I broached the subject of the Z, his face lit up and his eyes shone," says Katayama. "I couldn't have been happier with his response." Recalls Ghosn, now Nissan CEO: "It was obvious. I could not imagine reviving Nissan without putting the Z back on the road." Turns out the

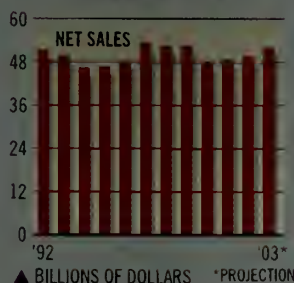
PROFITS ARE FINALLY UP AT NISSAN...



▲ BILLIONS OF DOLLARS

Data: Nissan Motor Co.

...BUT SALES REMAIN FLAT

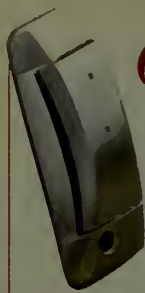


▲ BILLIONS OF DOLLARS *PROJECTION

the Z were style pioneers, both in Japan and America. "Nissan had the true sports cars," says John Yukawa, who is project head for the 350Z—and who quietly kept a group of Nissan designers working on the Z even when the line seemed headed for the junkyard. "That's why I signed up and why many others like me joined—in hopes of working one day on a Z." But Nissan then forsook its style heritage by focusing too much on bland, Toyota-style sedans. The result was a decade of

design ennui for Nissan, and a near-death experience as profits and sales plunged.

Ghosn has deftly turned this situation around. Wringing out savings from suppliers and scrapping excess factory capacity allowed Nissan to post a record net profit of nearly \$3 billion



DOOR HANDLE:
Clean lines

Ghosn says he's banking on Z-car luster to rub o

for the fiscal year that ended Mar. 31—a 12% increase over the previous year. Sales, though, grew less than 2%, to \$49.6 billion. Now, Nissan can no longer depend on cost-cutting alone to boost profits. The carmaker can push suppliers only so far. Already, Kawasaki Steel Corp. and component maker Calsonic Kansei Corp. have put Nissan on notice they'll fight further price concessions. To keep the profit momentum going, Nissan sales must rise soon and keep rising. "The real battle for Nissan is yet to come," says Takashi Oshika, a research director at Mitsubishi Research Institute, a Tokyo think tank.

Ghosn vows he will boost overall Nissan vehicle sales to 3.5 million by 2005, up from 2.5 million in 2001. And he plans to use the Z, which has a starting price of \$26,809, as part of his full-scale sales offensive. Already, Nissan has scored hits with cars such as the new Altima sedan and the G35 from the company's upscale sister brand, Infiniti. All together, Nissan is preparing to launch 28 new models worldwide—from luxury SUVs such as the Infiniti FX45 to U.S.-size pickup trucks and budget subcompacts—in the next three years. One goal of Nissan's big rollout is to shed its dowdy image.

As the 350Z heads for the showrooms, Ghosn's big hope is that a bit of Z-ness will rub off on other models, which could translate into higher margins for all Nissan cars. That's what happened when the redesigned, more muscular Altima was introduced last year: The car drew customers into Nissan showrooms, and, even if they didn't buy an Altima, many drove off with a Maxima or Sentra. A smash hit with a Z would draw in tens of thousands more. "It's not just another car in our lineup," says Ghosn of the Z. "It's really the symbol of the revival of our company." And a symbol of Ghosn's personal victory, too. A successful Z launch will seal his bid to run both Nissan and Renault in 2005—which would probably make him the most important auto exec on earth.

No wonder Ghosn, who's usually big on delegating authority, took a personal interest in this car. Throughout the Z's redevelopment, Ghosn kept designers on their toes, insisting on such details as making the speedometer easier to read and redoing the interior to make it more like Porsche and BMW. In the fall of 2000, at a viewing session in the courtyard of Nissan's main research and development center near Tokyo, he made a snap decision that sent his designers back to the drawing board just days ahead of the planned final design "freeze." The reason? Ghosn didn't like the Z prototype's single rear exhaust pipe. Real sports cars, he insisted, have two tailpipes. "That required a lot of re-

THE Z FAMILY TREE

FIVE GENERATIONS OF FASTBACKS



240Z

1969-1978

Base price Cars sold
\$3,526 523,529

The Z that started it all. Known as the "poor man's Jaguar," it offered performance and styling similar to an E-Type Jaguar at less than half the price.

Data: BW and company reports

280Z

1978

Base price
\$9,899

A chip off the block. Closely styled, pace-setting, but pumped up with a racer's 2.8-liter engine and other new features.



DESIGN TEAM:

Aoki and Yukawa with the 350Z

working," recalls chief designer Mamoru Aoki. While the new Z pays homage to earlier Zs, with its rear quarter windows and trademark circular "Z" insignia, the overall design is a radical departure from original. Indeed, Nissan explicitly rejected a retro look. Instead, it wanted something that incorporated the best of the past—such as the trademark hatch in back—reflected prevailing moods in the industry. Its broad shoulders and compact frame clearly echo recent designs by the setters such as Audi, BMW, and Porsche. What its designers refer to in Japanese as the car's *kibi-kibi* ("tight")

mimics a professional racing machine—the minimalist cockpit to its aerodynamic exterior. "We modeled after a Formula 1 car," says Aoki.

That's a real nod over from the 280Z's long snout and narrow body—key Z-car traits that had been retained in previous model changes. Another notable departure from the 280Z is the pricing strategy. Although Nissan

meet its pledge to keep the 350Z below \$30,000, the to-be models approach \$37,000. That's way below rivals, such as the \$51,600 Porsche Boxster S, but still pocket change for the younger drivers who were the original's most ardent fans. The starting price for a 350Z in 1969 was \$3,500—half the price of rivals. That's a \$17,000 today when adjusted for inflation.

This time, company officials say they're not aiming at first-time car buyers. Instead, "this is a good third car for somebody with a sedan and a truck," says Patrick Pelata, Nissan executive vice-president and product planning chief. Nissan spared no expense in packing the newest Z with standard goodies—from a powerful 287-horsepower engine to brushed aluminum trim on the dash and separately sha-

For Nissan models, raising margins across the board

300ZX
1989
Cars sold
\$29,900

scale. The
engine
styling
made it
and
—fore-
—flowing a
—in sales
—the
—gining of
—end
—Nissan
—AD

300ZX
1989-2000
Base price Cars sold
\$27,300 164,170

Twilight of the Z. The 300ZX offered plenty of comfort and horsepower. But with a price tag that eventually approached \$50,000 for a fully loaded model, it drove the Z to extinction

350Z
2002
Base price Cars sold
\$26,809 ???

The Z's revenge. Angular design with short overhangs sets it apart from its forebears. The powerful V6 engine pays homage to the 300ZX's muscle-car tradition.



seats for the passenger driver. Nissan figures the car will be a hit with thirtysomething lawyers and bankers as well as baby boomers with a nostalgic bent. "To me, it's a man's sports car," says U.S. sales and marketing chief Connelly.

As competition is heating up among midrange sports cars, even as demand has fallen in the past decade. In that market, the Z's price tag may yet prove a liability. "It's not much point in launching a car at an uncompetitive price," snipes Lewis Booth, CEO of Mazda Motor Corp., as the RX-8 sports car, to be launched next year, is expected to start at about \$20,000.

It was high prices that killed off the earlier Z line. The tab for a fully loaded 300ZX eventually ballooned to nearly \$50,000, a turnoff, even for a high-performance vehicle. To avoid that mistake, Nissan designed the current Z to share its costs among three models and so split the bill for develop-

ment. That's a big edge, because the cost of creating a new model from scratch averages nearly \$500 million. The Z also shares its V6 engine with the Altima, Maxima, and G35. Many parts will be shared are air-conditioning units. All seven different Nissan models will use the basic architecture by 2005, starting with 200,000 cars a year. Says planning chief Pelaez, "We'll have the same kind of economies of scale as the Mercedes-Benz C class cars or the 3 Series."

When it comes to looks, the shorter overhangs in front and back give it a rounded appearance akin to Audi's sleek TT roadster. At the

same time, the clean geometric shapes of the door handles, windows, and wheels are meant to identify it clearly as a member of the Nissan family. As for performance, early reviews say that the Z is dead-on in its attempt to strike a balance between sports car zest and value. "If you liked the original 240Z, you'll love the new 350," writes Csaba Csere, editor-in-chief at *Car & Driver*, who points out that the Z has nearly as much horsepower as a Porsche 911, a car that costs 2½ times the price.

Nissan expects to sell the bulk of the 40,000-50,000 Z cars it plans to produce annually in the U.S. Nissan will debut a roadster version of the 350Z in the U.S. later this year. U.S. dealers are betting that the Z will eventually outsell even the Chevrolet Corvette—which means annual U.S. sales of 30,000 units, a big number for a sports car. Chevy officials, though, insist they don't feel threatened. "Our buyers are Corvette people," says Ken Thompson, a sales manager at Frank Parra Chevrolet in Dallas. "The Corvette has a place of its own."

In the U.S., early signs for the Z are encouraging. Advance orders for the car already top 7,800 units. Nissan plans a major U.S. advertising campaign for the Z starting in August. The campaign will feature a new slogan for the brand, similar to the "Shift the Future" line being used in Japan.

Excitement is building back home in Japan, too, where Nissan is expected to sell several thousand Zs a year. Limited edition toy versions of the car

are trading on Japanese Internet auction sites. Nissan has begun an aggressive teaser ad campaign, showing a profile of the car under the slogan, "One step ahead: Meet the Z."

But even in the birthplace of the Z, some opinion-makers remain critical. Makoto Oura, chairman of Japan's biggest Z car club, says Nissan should have settled for a smaller, 2.0-

International Business

GENTLEMEN, START YOUR ENGINES

The Z faces strong rivals for the sports-car dollar



AUDI TT

AUDI TT (FrontTrak) The bold four-passenger coupe carries a base price of \$31,200 for 1.8-liter four-cylinder engine with 180 hp.

BMW Z3 A sleek sports coupe for two, priced at \$37,900 for a 3.0-liter engine with 225 hp.

HONDA S2000 This curvy convertible from \$32,400 for a 2.0-liter, four-cylinder engine with 240 hp.

MERCEDES-BENZ SLK230 ROADSTER This classy two-seater starts at \$39,400 for a 2.3-liter engine with 192 hp.

PORSCHE BOXSTER S Compact twin-seat convertible starts at \$51,600 for 3.2-liter engine with 250 hp.

Data: Company reports

liter engine and cheaper parts to make it more affordable to average Joes. Although Oura has one on order, he admits that "I bought it because it's a Z, not because I'm especially thrilled with the package."

That concern looks like the one warning flag as the Z begins to roll out. But Ghosn is betting drivers will forget the sticker price the minute they get behind the wheel and shift into first. If Ghosn is right, this car could be his greatest legacy at Nissan—good enough to trade in Le Cost-Killer for a new moniker, Mr. Z.

By Chester Dawson in Tokyo, with Larry Armstrong in Los Angeles and Joann Muller and David Welch in Detroit

BRITAIN

CAN SCARDINO GET PEARSON OUT OF THIS PICKLE?

So far, her growth strategy has only managed to shrink the stock

It was one of the great business tales of recent years. Texas native Marjorie M. Scardino takes over stodgy British blue chip Pearson PLC and electrifies the company and its share price with folksy cheerleading and a blaze of deals. Unfortunately, the story didn't end there. Like most media companies, Pearson is now in investors' bad books. The stock price, which had more than tripled under Scardino by the spring of

Maybe so, but for now she's likely to keep taking heat. Pearson's operating income before Internet losses and amortization for all of 2002 will likely be about \$945 million on sales of \$6.8 billion, according to Sanford C. Bernstein & Co. in New York. If so, that would be another flat-to-down year after a 6% drop in 2001. Investors are growing skeptical that Scardino will ever deliver the hoped-for high returns that once drove the stock

top of a 20% drop in 2001. (*BusinessWeek*, a division of McGraw-Hill suffered even worse back-to-back declines, as has *The Wall Street Journal*.) Pearson doesn't expect a recovery in 2004 and is considering additional cuts, the substantial ones already made in the *FT*, where Pearson gets 10% of revenues. Furthermore, education publishing, in which Scardino has invested more than \$7.2 billion, is proving more vulnerable to the economic downturn than she reckoned. With U.S. state and local governments slashing expenditures, Michael Nathanson, European managing director at Sanford C. Bernstein, says the market for U.S. school textbooks, where Pearson has placed the biggest bets, could decline by 3% this year. McGraw-Hill, a leading textbook publisher, faces similar pressures.

A SERIES OF STRUGGLES

- Education, which accounts for 60% of revenues, is under pressure from government cutbacks and lower sales of IT-related texts



- The *Financial Times* has been hit by a big decline in ad revenues

- Scardino was slow to cut back spending on Internet development, leading to big losses

- Last year's sale of the 22% stake in European broadcaster RTL took away some of Pearson's upside potential

- Scardino made pricey acquisitions that have been marked down by the market and earn low returns on capital

Data: *BusinessWeek*



To be sure, many of Scardino's problems are a result of tough environmental conditions, and for her part, she plays in part the victim. Few would deny she has shared Pearson's focus, but a conglomerate of three main businesses: education, which contributed most two-thirds of operating revenues to the *FT* Group; and publisher Penguin Group.

But Scardino could boost growth in these divisions by buying new properties in new markets are likely to span any major actions because investors consider her profile along with other vintage media executives. "She made her

2000, is now just below where it was at the start of her tenure in 1997. Not surprisingly, her moves, once applauded, are getting poor marks. "If she were to leave now, she would be judged a failure," says Matthew Owen, media analyst at Morgan Stanley in London and an early Pearson skeptic.

Scardino, 55, has a ready answer. "If you want to judge me by the stock price, fair enough," she says. "But to toot my own horn, I have changed the company entirely. It is a company with huge growth potential. The culture is [now] completely different, and people underestimate the importance of that to the company's ability to perform."

price skyward. Bernstein figures, for instance, that Pearson is only earning 3.3% on invested capital. They also worry that education, where Scardino has put most of her chips, isn't the growth industry that it's cracked up to be and that she may not be able to control costs in what is turning into a sharper downturn than expected. "If you look at the returns, it is a worse company now than when Scardino took over," says Terry Smith, CEO of London brokers Collins Stewart Ltd.

Worst affected is Pearson's crown jewel, the *Financial Times*. Ad revenues are down an estimated 20% this year, on

BACK TO MEDIA

Revenues haven't rewarded Scardino's success in refocusing

Scardino justified her deals on grounds that the world was entering a new age when the demands for information and educational materials would explode.

The vision may still be on the map, but the dream has been delayed. Scardino has few options besides controlling costs. Late in the day, she is sharply scaling back Pearson's ambitions in online education, where the company has blown about \$185 million trying

"We told KPMG Consulting: Texans should do government business online, not in line."



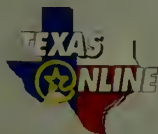
*Carolyn Purcell
Chief Information Officer, State of Texas*

*Gary Miglicco
Managing Director, Public Services, KPMG Consulting*

"KPMG Consulting and the State of Texas have certainly hit a home run with the people of Texas. In 90 days, we provided our citizens with TexasOnline ... establishing our place in the market.

"We've lowered the transaction cost for people to do their government business. The benefits are endless, and we've only begun to scratch the surface."

www.TexasOnline.com



"This is a very new opportunity in government providing services on the Internet. We saw this as a business problem, not a technology problem.

"So we created a solution where we not only build and manage the technology, but we manage the accounting, finance, marketing, public relations, customer service, and translation services.

"We're very proud to have just had our 5 millionth visit to TexasOnline."

YOU CAN HEAR THEIR STORY @ www.kpmgconsulting.com/results

BUSINESS SYSTEMS: STRATEGY IMPLEMENTATION RESULTS

KPMG Consulting

establish an education portal for consumers called The Learning Network. She has also slashed expenses at the online version of the *FT*. Overall Internet losses are expected to fall from \$215 million last year to \$93 million this year.

If times get harder, high-profile initiatives could be threatened. Expansion of the *FT*, which now has a 501,000 circulation, has been halted. In publishing, Scardino has deputized former Finance Director John Makinson, a possible successor, to take over the Penguin group. One task there is to make Dorling Kindersley, the flashy but money-losing British publisher that Scardino paid \$482 million for in 2000, profitable.

Investors are also waiting for that big payoff in education. Scardino turned Pearson into the biggest player in education overnight by making a knockout \$4.6 billion offer to Viacom Inc. for Simon & Schuster's educational publishing assets in 1998. Then she took what many analysts consider a step too far by paying \$2.5 billion, a 26% premium over the market, for a Minnesota-based educational testing company called National Computer Systems Inc. in 2000.

Will these businesses achieve the high growth Scardino expected from them? Bernstein forecasts that Pearson Education's revenues will grow by only 2% in 2002, to \$4.1 billion, and by just 3% in 2003. Sources close to the company, however, say that 5% per year is more realistic. The college and high school divisions remain strong, while professional and data management texts have fallen off sharply owing to the technology slump. International educational publishing, for which Scardino had big hopes, has been hurt by economic woes in Latin America. NCS scored a coup by securing \$315 million in U.S. government contracts for screening airport security personnel, processing immigration forms, and online education for the Navy. But it has disappointed in education software.

A mixed record. Yet Scardino seems to have retained the confidence of Pearson's board. "I am not sure I would bet against Marjorie Scardino," says Jonathan Newcomb, formerly CEO of Simon & Schuster and now a principal at Leeds Weld & Co., a New York-based private equity firm that specializes in education. Scardino says she plans to stay "as long as I can to prove that I can deliver on the promise of this company." Over the next few quarters, Scardino will show whether she is the talented manager she seemed to be early in her tenure or whether she was just another lucky CEO riding the boom.

By Stanley Reed in London

COMMENTARY

By Jack Ewing

DEUTSCHE TELEKOM NEEDS MORE THAN AN AX

By all accounts, Ron Sommer's days as Deutsche Telekom's boss are numbered. With the company's shares trading below their 1997 initial public offering price, Chancellor Gerhard Schröder—in a tough re-election fight—can no longer afford to support the embattled exec. *Auf Wiedersehen, Herr Sommer.*

Sommer's departure, though, will do nothing to lighten the giant telco's huge debt load of \$66 billion. The obvious solutions have all been tried or contain big downsides. Deutsche Telekom's new boss—may the Lord have mercy on his soul—must go further. So must the government, which still owns 43% of the company.

Here's a proposed plan: First thing, hold a rights issue. Yes, selling new shares at a discount to existing shareholders would dilute equity, and theoretically pummel them. But the shares of BT Group PLC and Dutch telco KPN rose after they used rights issues to help get debt under control. Investors welcomed the fresh capital and were willing to forgive the share dilution.

The new boss should also insist that the government accept some responsibility for Deutsche Telekom's woes. A big chunk of its debt stems from the cost of rewiring East Germany, an investment made when the state was the sole owner. Germany's government also profited hugely from the sale of third-generation mobile-phone licenses to providers, including Deutsche Telekom.

How can Berlin make amends? The politicians should stop playing

football with Sommer's head and allow the company to reduce the staff of 255,000 more quickly. The way to lower debt is to boost cash flow, which means cutting costs.

There's another favor the government can provide: Overrule regulators who have blocked the sale of Deutsche



SOMMER: On the way out?

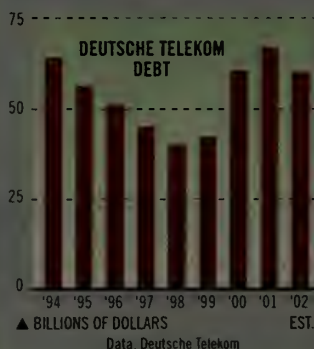
Telekom's cable-TV systems. John Malone's Liberty Media Corp. was ready to pay \$5.4 billion earlier this year, but the Federal Cartel Office nixed the deal after the media mo refused demands that he spend billions upgrading the systems. In respect, it's clear the regulators were wrong. Sommer's successor should take the job until the government clears the sale.

The good news about Deutsche Telekom is that its cash flow is still strong enough to fend off a crisis another two years. However, if something unexpected hits cash flow, Deutsche Telekom will have to consider more drastic solutions, such as a workout that forces bondholders (primarily international institutional

investors) to accept less than face value. No one expects such a step now. But then, no one predicted the current crisis—and Deutsche Telekom's 3 million German shareholders cannot afford another one.

Ewing covers German business from Frankfurt.

DRAGGED DOWN BY DEBT



EDITED BY ROSE BRADY

OUTH KOREA: FROM WORLD CUP HERO TO PRESIDENT?

occer euphoria lingers on in South Korea, co-host of this year's World Cup. The country's team had the best showing by an Asian contender in the history of the championship, making it to the semifinals. But the World Cup's most important impact isn't on Korea's sports world—in the country's tumultuous politics. This is a presidential election year, and there may soon be a strong new candidate: Chung Mong Joon, president of the Korean Football Assn., negotiated for Korea to be co-host and organized the

World Cup. Chung also hired Guus Hiddink, the Dutch coach who led the South Korean team to its successful run. To top it off, Chung, 50, is a member of the dynasty that ruled the mighty Hyundai *chaebol*, and is personally worth \$143 million.

Chung's adroit handling of the World Cup has suddenly given him the kind of national popularity necessary to make a serious presidential run. In the past month, Chung's ratings in the opinion polls have more than doubled, to 24%. That puts him within reach of ruling party candidate Roh Moo-hyun, who enjoys 26% support. Chung still trails opposition candidate Lee Hoi Chang by 5 points, but the election is five months away, and Chung has yet to declare his candidacy. "It's better to separate sports from politics," he recently told reporters. "I

don't have to agonize for some time over my position." Chung, who has served in Parliament as an independent for 14 years, predicts he will run. "It'll be too attractive an opportunity for him to pass," says one associate. Chung candidacy would make a wild presidential race—the country's most important election this year—even wilder. Just a few months ago, it seemed that Roh, a human rights lawyer, had waltz into the presidential Blue House and keep President Kim Dae Jung's Millennium Democratic Party in power.

But Roh's candidacy suffered when Kim's two sons were arrested for influence-peddling. Sick of corruption in politics, Koreans punished the Millennium Democrats in June local elections, handing 11 of 16 mayorships and governorships to the opposition Grand National Party. That spurred a dozen members of Roh's party to demand he be replaced as candidate—and several named Chung as their favorite.

It may seem ironic that Kim's party would consider drafting Chung, the ex-boss of Hyundai Heavy Industries Co.

Kim, after all, spent his presidency battling to reduce the *chaebols'* influence. But Chung ran a scandal-free World Cup, and Hyundai cooperated with Kim's government by breaking its group into three separate entities. Aides say that Chung, as president, might loosen some restrictions on big companies—such as the current limits to cross-shareholdings. But Chung backs Kim's Sunshine Policy toward North Korea, which advocates a conciliatory approach to the Stalinist regime.

A key decision time will come after by-elections for 13 parliamentary seats on Aug. 8. Roh has promised to review his candidacy after the vote, seen as a barometer for the presidential ballot. Yet any draft-Chung movement must be handled carefully. The Millennium Democrats chose

Roh after Korea's first-ever primary, which was held up as a key reform. "If Roh is dumped after such a process, the party's credibility will be seriously damaged," says Lim Seong Ho, a political scientist at Kyunghee University. So if the ruling camp wants Chung, it will likely have to disband the party, organize a new one, and launch a fresh campaign. Chung, who oversaw a sports miracle for Koreans, now needs the voters to help him score a different kind of last-minute goal.

By Moon Ihlwan in Seoul



CHUNG: Shrewd self-promoter

GLOBAL WRAPUP

KEY: ELECTION INTRIGUE

The crisis rocking Turkey's three-year-old coalition government means that key political and economic reforms will now be on hold. Since the currency's collapse in February, 2001, the government of center-left Prime Minister Bulent Ecevit had shown great success in fighting inflation, stabilizing exchange rates, and promoting structural reforms. That program has been backed by over \$16 billion in International Monetary Fund support. But key pro-reform members of the

government are now fleeing, including Deputy Prime Minister Husamettin Ozkan, once considered Ecevit's heir apparent in the Democratic Left Party. The immediate issue has been the declining health of Ecevit, who has been in and out of the hospital since May. Were Ecevit to resign or die, the prime ministership would fall to Deputy Prime Minister Devlet Bahceli, leader of the far-right Nationalist Action Party, which is part of the ruling coalition. The hard-line Bahceli, who has consistently fought reforms meant to draw Turkey closer to the Euro-

pean Union, is calling for early elections in November.

A key test now will be whether reformist politicians will coalesce around Ozkan, who says he will form a new party. These are likely to include respected figures such as Economy Minister Kemal Dervis and Foreign Minister Ismail Cem. Yet such a grouping would have little grassroots support and would likely fare poorly in general elections. Fearing shaky times ahead, ratings agencies have downgraded Turkey's foreign currency bonds.

By David O'Byrne in Istanbul

WHY LEVI'S STILL LOOKS FADED

CEO Marineau is reaching out to new markets, but style-conscious rivals continue to steal sales

Ask Philip A. Marineau, the relentlessly upbeat CEO of Levi Strauss & Co., what progress he is making to turn around the struggling jeans maker, and he sounds thrilled to tick off his achievements. "We have very strong financial discipline," Marineau declares. "We have good control over our inventories and working capital and capital expenditures. Our debt has been reduced."

All that is true. But there's a gaping hole in his progress report: Sales at the privately held company are still sliding, continuing five years of steep declines. From a high of \$7.1 billion in 1996, sales at the San Francisco-based company in 2001 skidded to \$4.25 billion, down 8% from 2000. Levi's market share, too, continues spiraling downward as the company faces an onslaught of competition from edgier upstart brands, such as Seven and Blue Asphalt. Its estimated U.S. market share in men's and women's

jeans is 12.1%, down from 18.7% in 1997, says consultancy Tactical Retail Solutions Inc. And on June 20, the company reported fiscal second-quarter sales of \$924 million, a 12% decline from a year earlier.

That's not an inconsequential shortfall for a PepsiCo Inc. marketing veteran who arrived nearly three years ago with a mandate to breathe some life into a tired brand. True to his Pepsi roots, Marineau, 55, lost no time reinvigorating the advertising. He generated lots of talk with special-effects-laden ads such as "Crazy Legs," which showed a guy ambling through traffic with his legs moving at impossible angles, or the epic "Odyssey," where a couple crashes through walls and sprints up trees. Still, in the fashion business, marketing is only as good as your latest merchandise. And that's not necessarily a strong suit for Marineau, who staked his claim as a product innovator at Pepsi on a single new soda, the now-languishing Pepsi One diet drink.

True, Levi's stagnation didn't start with Marineau. When he arrived, Levi's were seen by many teenagers and other young

consumers as jeans for the middle. Trouble is, that hasn't changed. Marineau won't launch a completely revamped set of offerings on store shelves until next spring: jeans with flared legs, jeans with low waists, and a line of "Type One," made of dark denim with bright stitching and large pockets. More painful is that Levi sat on the sidelines as denim made a fashion comeback starting a year ago, says Christine Guinee, an analyst at Moody's Investors Service. In May, Moody's affirmed its months-old "negative outlook" on Levi's \$1.9 billion of debt, suggesting that a downgrade may be needed later.

So far, the company's controlling family evinces no signs of restlessness with Marineau's pace of improvement. "If you ask our board, to a remarkable degree we're totally aligned with

MARINEAU

"It took a while to get into trouble and it takes a while to get out of trouble."



A NEW PATTERN FOR LEVI STRAUSS

How CEO Marineau is trying to breathe life into the brand

REVAMP THE PANTS A transfusion of talent from its European unit is helping Levi's come up with trendier offerings such as new jeans with flared legs or low waists. But many of the new styles won't hit store shelves until 2003.

GET INTO MORE STORES Marineau is moving into higher-end retailers like Neiman Marcus, Saks Fifth Avenue, and Bloomingdale's later this year. He's considering a push into discounters like Wal-Mart and Target. Attempts to tap into youth-oriented boutiques like Pacific Sunwear and Urban Outfitters, however, have met with mixed results.

BUILD BUZZ Eye-grabbing advertising, featuring hip street dancers and epic special effects, are once again generating interest in the Levi's brand. But without much new product to sell, there has been no real payoff so far.

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It has completely revamped styles, but
it won't be on shelves until spring of 2003

ing. Patience is worth extending to
says Chairman Robert D. Haas,
g that Marineau had warned from
ginning that a turnaround would
five- or six-year process. But he
st start delivering soon on his plan
the denim fashion window closes.
not as if Marineau has been sit-
on his hands. He is orchestrating
major initiatives beyond overhaul-
the core product line. He has been
to get his jeans into specialty
s, a sector of the retail industry
healthier than
mainstay depart-
stores. And after
s of industry
lation, Marineau
wledges that he is

NICE ADS, BUT...
Retailers say teens
deem the waist—and
the price—too high



with the idea of creating a new
to sell through discounters, such
d-Mart Stores Inc. or Target Corp.
eau figures these strategies should
ales growing again in 2003—well
he 2001 target he set soon after he
ed. "It took a while to get into
le," he says, "and it takes a while
out of trouble."

why has the product overhaul tak-
long? Essentially, Levi is still over-
g some bad habits formed in the
when the brand was hot and
designs were not essential to its
ss. Back then, Levi could get away
creating women's jeans from men's
rns, ending up with pants that
quite fit women's curves. It could
teen girls and older women as one
et, leading to jeans that were too
for moms and too high-waisted for
. To undo these habits, the compa-
s shipped in staffers from its more
on-oriented European division and
brainstorming sessions to suss out
what teen girls and older women
in their clothes. But the few new
is it generated in recent years pro-
anemic results.

make the brand more alluring,

Marineau is working to get his mer-
chandise into more specialty retailers
frequented by the young and hip. It's
proving to be a tough slog. "They're too
plain," complains Bree Edmunds, a 19-
year-old shopping at the Hillsdale Mall in
San Mateo, Calif., who wears labels
ranging from Old Navy to Calvin Klein.
"There's just not enough style to them."
Levi is testing jeans in 12 Pacific Sun-
wear of California Inc. locations but so
far, sales have been spotty. Some cus-
tomers view the \$78 price tag as too
steep, while others haven't liked
the fit, finding the waistband too
high even on jeans labeled "low-
rise," says a salesclerk at a store
in Newport Beach, Calif. Other
chains don't think the Levi's
brand passes the cool test.
Steven Strickland, senior vice-
president of marketing at 180-
unit Wet Seal Inc., says he's not
ready to carry Levi's because
"it's not on the radar screen of
young women now."

Levi has made some progress
moving upscale into such chains
as Neiman Marcus, Saks Fifth
Avenue, and Bloomingdale's, all
of which plan to carry Levi's
later this year. "Many customers
want an all-American jean, and
Levi's is a name associated with that,"
says Darcy Penick, an assistant buyer
with Neiman Marcus Group Inc.

Marineau also is considering whether
to move downmarket, getting Levi's into
the discounters that are grabbing a ris-
ing share of apparel sales. Analysts like
the sales potential of such a move. But
the marketing risks are considerable for
a company that is striving for an injec-
tion of cool. Even if Levi creates a new
brand for the discounters, it would like-
ly still use the Levi's name somewhere
on the tag. That could complicate its ef-
forts to polish its image with fashion-
conscious shoppers. "The brand's not cool
when you're at Target [looking] for de-
tergent and you see a rack of Levi's,"
sniffs Wet Seal's Strickland.

The Levi's name is so well-known that
"people are predisposed to the brand,"
argues Marineau. "So, if we get the
product right, they'll buy." But that's
exactly the problem: He hasn't got the
right product yet. Until he does, Levi
will be left hugging its middle-aged cus-
tomers' expanding waistlines—and its
own shrinking sales.

By Louise Lee in
San Francisco

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GM GAMBLES THAT SIZE DOES MATTER

But new Hummers face cost constraints and a gas-guzzler backlash

Jack Guy, a Malibu (Calif.) photographer, has long admired the macho image of the Hummer H1, the civilian version of the U.S. Army's Humvee assault truck. But the Hummer's huge girth and \$100,000 sticker price put it out of Guy's range. So when General Motors Corp., which acquired Hummer from AM General Corp. in 1999, started taking orders for its new smaller and—at \$50,000—far cheaper Hummer H2, the 40-year-old Californian finally bit. Guy's pewter-colored H2 should arrive in a few weeks. "The H2 looks like the toughest truck on the road," he boasts.

GM is betting hundreds of millions of dollars that there are plenty more Jack Guys out there. It wants to boost sales of the Hummer line, which now total about 700 a year, to roughly 200,000 a year by the end of the decade. Eventually, GM hopes each H2 will generate up to \$15,000 in profit, with the Hummer line becoming as profitable as the Cadillac division, which earns about \$500 million a year. Plans are also afoot to produce a \$35,000 SUV called the H3 and a Jeep Wrangler-like H4. "People don't appreciate how important Hummer is to GM," says GM Vice-Chairman Robert A. Lutz. "It's going to be a big moneymaker."

Perhaps, but GM's gambit is hardly risk-free. For starters, GM has to hope that the environmental lobby's continued push for tougher fuel economy standards doesn't succeed to the point of undercutting the market for gas-guzzling sport-utility vehicles—a real threat given pending legislation in California that would force SUVs to achieve better mileage. Plus, the federal government is mulling stricter fuel stan-

dards for the 2005 to 2010 model years.

Moreover, Lutz will be hard-pressed at a time of corporate belt-tightening to find the money to design, build, and market future models. "GM will support Hummer because it will make them money, [but] what other parts of

means Lutz may have to grab GM's other divisions to come up with enough cash to build SUVs that are Hummers, not just Chevy trucks dressed in military garb.

Indeed, that may be exactly what happens as GM's engineers scramble to build the new H3 on the cheap. GM wants to put the SUV on the platform of the forthcoming Chevy Colorado pickup. But designers gripe that the result will be a tall, upright vehicle, not the low, grimacing road warrior consumers associate with the Hummer name. "The H3 could make or ruin the brand," concedes one GM product development executive.

Then there's the struggle with federal economy standards. Fortunately



the business do you sacrifice?" asks James N. Hall, an industry consultant at AutoPacific Inc. And GM designers and engineers face the challenge of mass marketing the Hummer while maintaining its current cachet. "If Hummer sells too many, it loses its exclusivity," notes DRI-WEFA analyst Rebecca Lindland.

GM's big bet on the Hummer comes during a period when the cash-strapped auto giant has already whacked \$900 million from its capital budget, to \$7.1 billion this year. The cash crunch has forced GM to delay the launch of the H3 by six months to mid-2005, while divisions like Buick and Saab have had proposed new models nixed. That

the H1 and H2 are classified as medium-duty trucks and are exempt from the standards. But the smaller H3 and H4 lines won't fit through the loophole. At the same time, environmentalists continue to try to repeal the exemption for medium-duty trucks. Losing those exemptions, warns the Sierra Club, "would devastate the H2."

For its part, GM remains undecided. Lutz views the Hummer as the antidote to SUVs "that are becoming minivans or another form of transportation." Now, the question is whether there are enough Jack Guys out there to turn the Hummer into a winner.

By David Welch in Detroit

THE NEW DEAN SHAKING UP BERKELEY'S B-SCHOOL

Campbell take the MBA program mainstream?

...n Campbell may have been a mild-mannered congressman from Silicon Valley, but he never shied from controversy. For one thing, a Republican moderate was elected to the San Francisco Bay Area Democratic stronghold. And although he was a lifelong Republican, he frequently took stands that veered from the party line. As the ranking member of the House International Relations Committee, for example, he led party leadership when he took the charge of the U.S. intervention in Kosovo and he alienated colleagues when he pushed to lift sanctions against Cuba, citing the impact on its citizens. Now, the former senator is launching a new crusade as dean of the Haas School of Business at the University of California at Berkeley, mid-August. Campbell replaces John D'Andrea, who left to teach at London Business School.

THE FORMER POLITICIAN IS A SEASONED FUND-RAISER



...also a *BusinessWeek* columnist. Even before he is officially installed, Campbell is challenging the B-school's identity, planning to shift the emphasis away from its specialty—entrepreneurship—and push for a more mainstream MBA program. "The curriculum is no longer appropriate," says Campbell, "Haas has focused strongly on entrepreneurship, and now its graduates' alumni don't have the same opportunities as graduates of other schools." He could be fighting words at a

school that practically invented the business incubator. At the least, it's a stark departure from the hallmark Haas focus on innovation. Says Tyson: "I don't think [the entrepreneurial offerings] are in conflict with an education that emphasizes business basics."

Campbell is part of a boomlet of deans who come from outside academia. They're often chosen for their real-world

as academic values," says Edward A. Snyder, dean of the University of Chicago Graduate School of Business.

Persuading donors to open their wallets for poorly funded Haas was one thing the search committee had in mind in choosing Campbell. After all, he raised more than \$23 million for his various political campaigns. Says Aurin Sarin, a 1978 Haas grad and a member of the search team: "We wanted someone [with] established relationships in the Bay Area, someone who could paint a vision of where we want to go...and then to marshal people to that place."

Bringing money in is especially urgent these days, as state allocations for public universities are being slashed. Campbell vows he'll try to persuade the state legislature to raise tuition—even though other deans have tried and failed. Out-of-state students now pay \$22,000 a

year, in-state rates are \$11,700, and every student is eligible for California residency after one year of a two-year MBA program. By contrast, other top schools charge more. At University of Michigan B-school, resident tuition is \$27,600.

Campbell has already won a few early battles. He got a green light to increase the faculty size from 65 members to 90. And he's raising pay, currently some 25% below typical salaries elsewhere.

Still, Campbell's main focus for Haas will be to bring a bit of his own public service mentality to campus. After Watergate,

law schools worked ethics into the curriculum and the bar exam, and Campbell believes it's a similar watershed moment for business education. In the face of today's corporate scandals, teaching ethics is no less than an obligation, he says. Grads need to learn that "there's something more important than tempting the ethical breach, because [these days], why should an investor trust an American corporation?" It's a stressful time, but Campbell doesn't scare easily.

By Jennifer Merritt in New York

THOMAS J. CAMPBELL

BORN Aug. 14, 1952

EDUCATION BA and MA in economics, University of Chicago, 1973; JD, Harvard Law School, 1976; PhD in economics, Chicago, 1980

CAREER HIGHLIGHTS

Clerked for Supreme Court Justice Byron White, 1977-78; spent five terms as a Republican U.S. congressman from the San Francisco Bay area; served on the House International Relations Committee 1989-93 and 1995-2001

FAMILY Brought up in Chicago as one of eight children of a federal judge and of a homemaker who tutored her children in French; has been married for 23 years to Susanne, a specialist on Russia

experience in business or politics, which in turn helps draw needed funds to the halls of ivy. Douglas T. Breeden, dean of Duke University's Fuqua School of Business, ran an investment firm. Robert J. Joss is dean of Stanford Graduate School of Business, while Bruce G. Willison has led the University of California at Los Angeles' Anderson School of Business since 1999. Both were bank executives before becoming deans. Campbell, however, is "a blend: He's got political experience, external connections, as well



TRAINING

FOR UPS MANAGERS, A SCHOOL OF HARD KNOCKS

Execs share the kind of gritty life experiences of some workers

At United Parcel Service Inc., rules are religion. Without them, UPS could never move 13.5 million packages to their destinations on time each day. But two years ago, Mark J. Colvard, a UPS manager in San Ramon, Calif., had to decide whether to buck the system. A driver needed time off to help an ailing family member, but under company rules he wasn't eligible. If Colvard went by the book, the driver would probably take the days anyway and be fired. If Colvard gave him the time off, he would catch flak from his other drivers. Colvard wound up giving the driver two weeks, took some heat—and kept a valuable employee.

Six months earlier, Colvard admits, he would have gone the other way. What changed his approach? A month he spent living among migrant farmers in McAllen, Tex., as part of a unusual UPS management training experience called the Community Internship Program (CIP). After building housing for the poor, collecting clothing for the Salvation Army, and working in a drug rehab center, Colvard said he was able to empathize with employees facing

crises back home. And that, he says, has made him a better manager. "My goal was to make the numbers, and in some cases that meant not looking at the individual but looking at the bottom line," says Colvard. "After that one-month stay, I immediately started reaching out to people in a different way."

CIP began in 1968 as the brainchild of UPS founder James Casey, who wanted to open up the eyes of UPS's predominantly white managers to the poverty and inequality exploding into violence in many cities. By now, nearly 1,200 current and former middle managers have moved through the program. And it has evolved into an integral part of the UPS culture, teaching managers the crucial skill of flexibility at a company that is trying to fit a diverse base of employees into its rigid rules-based culture, which prescribes everything from how delivery people should carry their keys to how many steps they should take per second. UPS needs rules, but it also needs managers capable of bending them when necessary. "We've got

TODAY'S LESSON, EMPATHY: *Fir bikes at a New York community*

330,000 U.S. employees," says Wofford, the CIP coordinator graduate of the program. "There are all kinds of personalities and all kinds of diversity. We need managers to manage those individuals."

Therefore, each summer UPS sends 50 of its most promising executives to the company's 2,400 managers brings them to cities across the country where UPS partners arrange for community service projects aiding disadvantaged populations. The problems encountered there—from transportation to housing, education, and health care—include all kinds of issues many UPS employees face every day. By forcing managers to grapple with the same problems, UPS hopes to awaken them to the realities many of their employees face, bridging the cultural divide that separates a white manager from an African-American driver or an upper-income executive from a worker raised in the South. This is a necessity for UPS, where minorities—many from poor neighborhoods—make up 35% of the workforce and 52% of new hires. Three out of four managers, meanwhile, are white.

In New York this summer, UPS managers visited the emergency department at Bellevue Hospital, tutored inmates at Sing Sing in interviewing skills, and provided meals to the homeless. The experience took them far outside their comfort zones in ways large and small, whether it was using public transportation for the first time in years or having an initial encounter with violent crime, such as the triple homicide that took place a few steps from the Henry Street Community Center, the community center they lived. "A lot of rising stars who came off to this program have gotten serious about themselves. That leads them to be more open with solutions," says Jeffrey A.

nenfeld, an associate dean at Yale University's School of Management who has studied the program. After CIP, "instead of reacting, they would listen. They showed incredible skills of empathy."

UPS values those skills. In 34 years, it has never ended the program, even during

the cost-cutting that accompanied the September 11 terrorist attacks or the September 11th strike in 1997. Excluding the cost of paying managers' salaries throughout the program, UPS's costs amount to \$10,000 per intern, or about \$1 million since CIP's inception. UPS concedes that it has no concrete evidence



e program works. But that's not ing, says Noel M. Tichy, a Uni- of Michigan B-school professor ran General Electric Co.'s ned training program at Cro- p, N.Y., in the 1980s. The impact n the best programs is hard to e. "You think we ever measured ou can get out of a Crotonville ?" Tichy says. "It's anecdotal."

managers who have been h the UPS program say it made ore likely to search for uncon- al solutions. Patti Hobbs, a divi- nager in Louisville who spent a on New York's Lower East Side , remembers being impressed by

UPS DELIVERS A REALITY CHECK

WHAT IT IS

ommunity Internship Program is UPS managers into low-in- communities to make them understanding as supervisors

BEGINNINGS

ounder James Casey started rogram in 1968 as a way to ex- mostly white managers to ty and inequality

HOW IT WORKS

managers a year spend a h living among the poor. They serve meals to the homeless, el recovering drug addicts, migrant farmers

LOCATIONS

York City; Chicago; Chat- ga, Tenn.; McAllen, Tex.

COST

\$10,000 for each participant, illion since inception, exclud- terns' salaries

ative ideas of uneducated addicts ring teens away from drugs. Re- that the best solutions sometimes rom those closest to the prob- le immediately started brain- ing with the entire staff instead of or managers. Says Hobbs: "You o think there's no one person, re- s of position, who has all the an- The answers come from us all." month living among the poor hange the world. But it might s managers see their employees e than just a cog in a very effi- achine.

By Louis Lavelle in New York

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THE INTERNET

THE HIGH COST OF FREE SHIPPING

E-tail incentives may turn out to be a big step backward

Just as online retailers are finally starting to make profits, a price war is breaking out that could send them back into the red. The recent flurry of promotions started last month, when Amazon.com Inc. lowered the order limit eligible for free shipping to \$49 from \$99. Then Buy.com Inc., which sells everything from consumer electronics to books and CDs, did away with shipping charges on many products and began undercutting Amazon's book prices by 10%. Not to be outdone, Circuit City and Best Buy jumped in with their own free shipping offers, while Barnesandnoble.com began shaving 30% off books published this year.

It's all about revving up sales. Last year, amid the recession, online sales growth slowed to 25% from triple-digit growth in previous years, as e-tailers slashed marketing and raised prices. Now, the heat is on for companies to grab a greater part of this year's online sales, expected to rise 30%, to \$39 billion. "Everyone is under pressure to increase revenue," says David Dowhan, vice-president for marketing at Drugstore.com Inc., which in May began offering 5% discounts to some customers who spend more than \$200 a year.

It's a risky strategy. The online retailing industry has just started to become more profitable. About 56% of the 109 largest online retailers had operating profits last year, up from 43% in 2000, according to a survey by Boston Consult-



ONLINE PROMOTIONS: BACK FROM THE GRAVE

E-tailers are slashing prices, offering free shipping, and testing other promotions. Here are some of the strategies and risks:

THE PROMOTION	THE RISK
FREE SHIPPING Amazon.com, Overstock.com, Best-Buy.com, and others are offering free shipping to lure customers. In June, Amazon began testing free shipping for orders of \$49 or more, down from a \$99 minimum.	Margins will be squeezed. On a \$60 order, Amazon used to make \$15 in gross profit. Now, it'll make \$12. Amazon is betting the offer will raise revenues—and boost profits.
PRICE WARS In June, Buy.com, which sells everything from books to phones, offered book prices 10% cheaper than Amazon's. In addition, Buy.com threw in free shipping except for speakers and other heavy items.	The e-tailer will eat the shipping costs and lose money on low-margin, single-item orders. It's hoping that customers, drawn by free shipping, will order multiple items.
CONDITIONAL DISCOUNTS In May, Drugstore.com began offering customers who spent less than \$200 a year at the site 5% discounts on every order above \$200 annually. It hopes this will lift overall sales.	Consumers stocking up on low-margin items, like Q-tips, could hurt profits. Drugstore.com is testing the promotion on a small group of people and will discontinue it if necessary.

ing Group Inc. and Forrester Inc. for Shop.org, an arm of National Retail Federation. Discounts and wide-open free shipping could harm e-tailers' profits, especially if they drag on for months and become permanent. "Companies have made great strides toward profitability and I worry we're stepping back again," says analyst Ken C. Jupiter Research.

The key company to watch is Amazon.com. The largest player in online retailing, with more than \$1 billion in annual sales, introduced free shipping in January on orders of \$99 or more. The goal was to stimulate sales. The offer came with a catch: The shipping time was three to five days longer than normal. It worked. In the first quarter, Amazon's sales of books, music, and electronics rose 8%, to \$1.1 billion, up from a 5% increase in the fourth quarter. In the third quarter, the company's loss narrowed to \$23.2 million, from \$234 million in the second quarter.

Now, in lowering the shipping threshold to \$49, Amazon is betting that it can lure more sales, increase profits and offsetting costs. More than half of Amazon's sales are under \$50, often in item shipments that lose money on, says Mark Rowen of Prudential Securities Inc. If Amazon gets a customer to buy three items instead of one and wait longer for delivery, it can offset the cost of shipping on postage and ship more efficiently.

The key is increasing sales enough to make up for the loss in giving away shipping. On a \$60 order, the company used to make a gross profit of about \$15. Now, with free shipping, it's about \$12, estimates analyst Safa Rashtchy. Bancorp Piper Jaffray says sales don't get a lift, but could lose as much as \$100 million this year on sales of \$1 billion, estimates Rashtchy. Instead of the \$92.5 million he is still forecasting, the question is at what point lower margins not get n-

increased sales," says Prudential's n. "I don't think they know the or to that."

y.com's aggressive discounting interfere with Amazon's plans. om is in the midst of a turnaround. ler and CEO Scott Blum says cost-g, including an 82% cut in staff the peak level in 2000, improved ess so much that Buy.com earned st net profit in the first quarter. have been focused internally, not ally," says Blum. "Now, we're pre- to compete." With its free ship- and 10%-off offer, Buy.com is hop- to increase orders for books, which ally have 20% to 25% margins. In ast, consumer electronics, which up most of its sales, have 10% ns. Although Blum expects gross ns to tighten to 12% from 15% he is betting he can pull in more ues and increase profits.

far, Amazon.com hasn't responded deeper discounts. It enjoys an enor- size advantage over Buy.com, with es Buy.com's \$380 million in rev- It figures Buy.com, which has only lliion in cash, won't be able to sus- ts promotions long enough to take business away. Market analysts hat unlimited promotional offers lly generate a flurry of excitement, terest quickly tapers off, making it lt to cover increased costs. Blum, er, is adamant that he'll be able to sales profitably at Amazon's ex- . In the three weeks since he d prices, Buy.com's average daily have increased to \$1.2 million, up rom about \$800,000, Blum claims.

ier retailers are eyeing Buy.com y. "We watch the competitive en- ment, and we know it's important e customer and to us," says Scott fer, senior vice-president at Best- om Inc., which on July 2 began ng a free shipping offer for the ime in two years. If more aggres- discounting works for Buy.com, its etitors, including Amazon, may to stick with their promotions or expand them—even if they're not g off financially.

e danger is that deep discounts promotional gimmicks will once become standard operating pro- e for e-tailers. The last time on- romotions spiraled out of control, tributed to 325 e-commerce com- s going out of business in 2000 2001. If history repeats itself, a thing for shoppers could again dire consequences for this still- e industry.

By Heather Green in New York

WHAT'S BUGGING BIG BLUE

Investors fear that Corporate America's woes will cast a shadow on IBM's services business

Last year, investors flocked to IBM as a safe haven in the tech down- turn. Its stock soared more than 40% during 2001, to close the year at 121. But this year, investors have fled. The company's shares have slid more than 40%, compared with an 11% decline for the Dow Jones industrial average and a 20% drop in the Stan- dard & Poor's 500-stock index. On July 1, IBM stock hit 67.6, its lowest level in four years. It now trades at about 70.

What's ailing Big Blue? The soft economy, accounting concerns, and a continuing slump in tech demand certainly hurt the company in the first half of the year. But it took the scandal at WorldCom Inc. in late June to send IBM shares to their new low. WorldCom's fi- nancial woes threw doubts on its services contract with IBM ri- val Electronic Data Systems Corp., which gets nearly 3% of its revenues from WorldCom.

Investors are spooked that similar troubles throughout Corporate America could hurt IBM's serv- ices business, which at \$35 bil- lion is the world's largest. Indeed, its customers include struggling Italian car- maker Fiat and trou- bled telecom-gear maker Lucent Tech- nologies Inc. "There's a lot of worry about the services business," says analyst Steven

Milunovich of Merrill Lynch & Co. "The comfort level with IBM as a safe haven has lessened."

IBM is hardly in crisis, but there is some reason for the worry. The com- pany's services group, which helps cus- tomers dream up, build, or manage com- puter systems, accounts for 41% of the company's revenues and 47% of its pre- tax profits. Now, sagging profits have forced many IBM clients to cut back their services contracts. Long-distance player Sprint, telecom-equipment-maker Nortel Networks, and retailer Ames Department Stores are just a few IBM customers that have restructured

contracts in recent months. In a June interview, IBM Global Ser- vices head Douglas Elix said re- worked contracts were cutting a few percentage points of growth from the services unit—the company's growth engine in re- cent years. Nevertheless, he says, "most of the tough adjust- ments have been done or started."

New CEO Samuel J. Palmisano, who took over from Chairman Louis V. Gerstner Jr. on Mar. 31, is moving fast to adjust to the difficult eco- nomic times. He's sticking with the company's fun- damental strategy of providing a range of software and hard- ware to customers—all wrapped together with the company's white-glove service. But he's fine-tun- ing the approach by trimming ex- penses, exiting poorly per-

PALMISANO:

The CEO is moving further away from IBM's factory roots



forming, low-margin businesses, and moving the company further away from its manufacturing roots. In the past six weeks, for instance, the company has sold off a chip-packaging plant in Endicott, N.Y., and shut down aging chip-production lines in Burlington, Vt.

The chief executive also is pushing the 315,000-person company to be more nimble. For example, he has given 400 sales execs the ability to cut prices on the spot to close deals, in addition to the 60 managing directors who could do so in the past.

Will Palmisano's moves be enough to put IBM back on track? They're a solid start. Palmisano's house-cleaning will help the company begin growing again when the economy perks up. Still, he has substantial work ahead of him to get IBM back to its market peak. The services group, in particular, may not be the growth engine for the company that it has been in the past. Though it averaged 12% growth over the past five years, the unit boosted revenues 5% last year and is expected to increase them only 2% this year, to \$35.7 billion, according to Sanford C. Bernstein & Co. IBM's total sales from continuing operations are expected to drop 4% in 2002, to \$79.9 billion, while net income falls 12%, to \$7.1 billion, Bernstein says.

Palmisano will likely have to turn to IBM's software business to drive revenues. The unit sells businesses everything from software to run their mainframes to programs for Web commerce. Software revenues are expected to be flat this year at \$12.8 billion, Bernstein says, but there are some gems that could take off in the years ahead. For example, IBM has about 30% of the market for application server software, which handles e-commerce programs for corporate networks. That market is expected to grow 15% annually in the next five years, rising from \$2.3 billion in 2001 to \$4.4 billion in 2006, according to researcher IDC.

IBM is taking steps to capitalize on such opportunities. This spring, the company introduced a new version of its application server, called WebSphere, that technology analysts, including Tyler McDaniel of market researcher Hurwitz Group Inc., say is a substantial step forward. And this fall, the company will release a new, streamlined version of WebSphere for small and medium-sized businesses. It's also laying the ground-

undancy, and market IBM as an integrated software brand, many analysts say. For example, while IBM acquired the database software maker Informix last summer, the company has fully integrated Informix's products into its own database offering, and not had any major layoffs in the process. "If they are going to turn around, they need to leverage size and act more quickly,"

Thomas Bittman, vice-president and senior research analyst at Gartner.

Most Wall Street analysts are skeptical of IBM's ability to retool quickly. In the past few weeks, at least 16 of 21 analysts covering IBM have lowered their earnings and sales estimates for this year and next. For the most part, Wall Street remains concerned about weak spending. But investors also want the company to change its accounting practices to disclose more financial information. For example, investors want to know how much income IBM gets from its asset and real estate sales. "They give little visibility but nearly as much a need," says Ken Smith, a portfolio manager at Munder Capital, which holds 2.3 million shares of IBM after selling more than 400,000 shares in the first quarter. "It makes me leery of investing in IBM a large holding."

The next milestone for IBM comes on July 17, when it reports earnings for the second quarter. Investors as Smith are looking for signs of improvement—especially in services, software, and microelectronics. Gold Sachs & Co. analyst Laura Coniglia expects IBM to report \$1.5 billion in net income for the quarter, on \$19.0 billion in sales from continuing operations. If the company can meet expectations for the second and third quarters, she would begin the process of stabilizing the stock, she says. With investors and analysts wary, IBM will be a show story for the rest of the year.

By Spencer E. Ante in New

BIG BLUE'S BLUES

IBM's stock sank to a four-year low of \$67.60 on July 1. Here are the problem areas driving down its shares and what the company is doing to fix them:

IBM GLOBAL SERVICES The division's sales dropped 3% in the most recent quarter, to \$8.22 billion. Customers are paring back contracts; new deals are taking longer to sign. Now, in the wake of WorldCom, investors are fleeing services firms that may be exposed to troubled companies.

RESPONSE: IBM has laid off about 2,000 service employees. It's using automation and foreign workers to lower costs. Big Blue also is selling more aggressively to midsize clients.

MICROELECTRONICS Its chipmaking group is expected to lose \$233 million this year, after making \$284 million in pretax income in 2001.

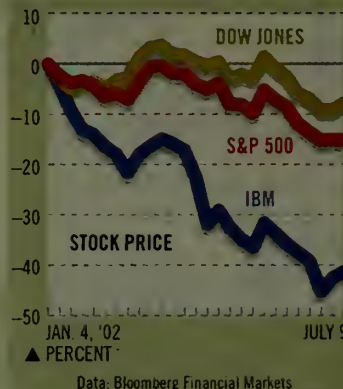
RESPONSE: IBM is shedding its low-margin manufacturing. In the last month, it laid off 1,500 workers and shut down aging chip production lines in Burlington, Vt.

COMPUTERS IBM's server and PC sales are expected to decline 10% this year, to \$10.7 billion, because of weak demand.

RESPONSE: After an overhaul of the PC group that outsourced desktop manufacturing and eliminated 19 of 22 product lines, the business is on target to turn a small profit this year, following a \$153 million pretax loss in 2001. It's also introducing several new servers later this year.

ACCOUNTING In the past, IBM used financial levers, such as gains from its pension funds, to boost profits. The accounting practices were legal, but some investors say they gave an overly rosy view. Now, partly because of increased scrutiny of accounting practices, IBM can't use its old practices to help profits.

RESPONSE: In March, IBM released more data in its annual financial statement. It now breaks out intellectual property income as a separate line item, instead of combining it with SG&A to make overhead expenses look lower. Analysts still want more information.



DATA: SANFORD BERNSTEIN, COMPANY REPORTS

work to move into promising new markets. On July 9, IBM and Nokia announced an agreement to develop software that distributes digital media securely over wireless networks. "This is the next generation of e-business," says Rodney C. Adkins, general manager of the IBM group that makes software for mobile phones, handheld computers, and other devices.

Still, there's more work to be done. The software group needs to knock down more walls between its hodgepodge of groups, eliminate more re-

as Smith are looking for signs of improvement—especially in services, software, and microelectronics. Gold Sachs & Co. analyst Laura Coniglia expects IBM to report \$1.5 billion in net income for the quarter, on \$19.0 billion in sales from continuing operations. If the company can meet expectations for the second and third quarters, she would begin the process of stabilizing the stock, she says. With investors and analysts wary, IBM will be a show story for the rest of the year.

By Spencer E. Ante in New

ED BY NEIL GROSS

LAB RAISES A VIRUS—AND LOTS OF QUESTIONS

NTISTS HAVE CREATED A LIVING VIRUS on scratch—and opened up a Pandora's box. The feat, reported on July 11 in *Science*'s online edition, means that if the genetic sequence of a virus is known, researchers can probably construct it from genetic building blocks in a test tube or even in deadlier versions. "This ability creates a situation of peril for all humanity," says Paul Root Wolpe, senior fellow at the University of Pennsylvania's Center for Bioethics.

Wimmer has a point. David Wimmer, a molecular geneticist at State University of New York at Stony Brook and leader of the virus-creating team, believes that there is a real danger because someone could create smallpox or look up Ebola virus. But "there would be enormous ethical value to

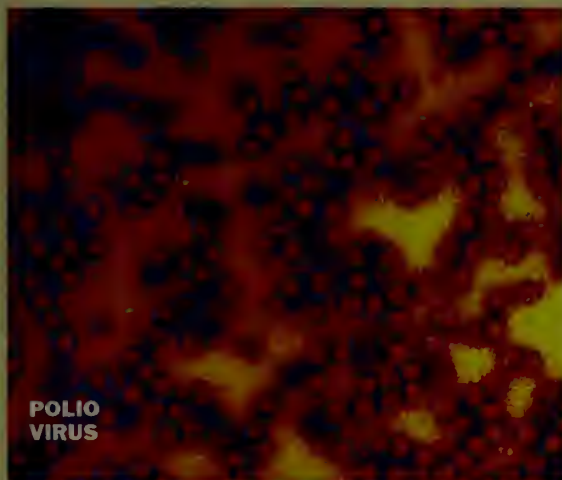
work," he adds. It could lead to crucial insights as well as dramatically deepen scientists' knowledge of how viruses work—how they can be defended against. Wimmer's experiment was conceptually simple, if technically difficult. His team began with the known genetic sequence of polio virus, whose code Wimmer read more than two decades ago. Then, with funding from the Defense Advanced Research Projects Agency (DARPA), the scientists synthesized bits of DNA and strung

them together into a chain roughly 7,400 molecules long, making a DNA copy of the polio virus' genes. Next, they used a natural enzyme to copy the DNA into RNA—the genetic material used by the virus nature created. Finally, they stuck the RNA into a special sauce filled with chemicals and bits of cellular machinery, such as protein factories called ribosomes. Almost magically, the RNA copied itself and began to make the proteins and other components of the real virus. The result: complete viruses that are just as infectious as their natural counterparts.

Wimmer downplays the idea that he has created a living thing in his lab. "I do not want to say that we created life in a test tube because we would be in deep trouble," he says.

The polio virus, he argues, is merely "a chemical with a life cycle." Ethicist Wolpe agrees that the key issue is not whether life was created but rather the potential for terrorists and others to fashion dangerous pathogens they wouldn't have access to otherwise.

The right response? We need to take this threat seriously, says Wimmer—and develop the necessary vaccines and other countermeasures: "It's very important that there is political fallout from this work." Undoubtedly, there will be. *John Carey*



THE LITTLE ENGINE THAT COULD... ALTER BUSINESS TRAVEL

ON JULY 13, AN ELITE GROUP of invited guests is to gather at Albuquerque's airport for the unveiling of a breakthrough in business travel. Eclipse Aviation will display on the tarmac its first Eclipse 500—a twin-jet, six-seat aircraft designed to slash the cost of flying a jet and give executives a way to avoid big-airport hassles. Soon, they'll be able to hail an air taxi that whisks them straight from an airport near home to another close to their final destination.

The Eclipse 500's sticker price is less than \$850,000, or a quarter of the popular Cessna Citation's. And projected operating costs are just 56¢ a mile, or about half that of any jet now flying. With those numbers, there is no shortage of buyers, such as Aviace, a Swiss startup that wants 112 planes for a network of air-taxi franchises around Europe.

One key to the Eclipse 500's performance is the latest EJ22 jet engine from Williams International in Walled Lake, Mich. Roughly the size of a bongo drum, the engine made its maiden flight on May 30. The Eclipse 500 is expected to take to the sky in a few weeks. *Otis Port*

BEATING TUMORS WITH A SCORPION'S TOUCH

MORE PHYSICIANS WILL test a new treatment for brain tumors based on an unusual ingredient: the venom of the giant yellow scorpion. Developed by Molecular Inc. in Birmingham, Ala., the drug contains a synthetic version of a protein in the venom and was tested in 18 patients suffering from glioma, a type of brain tumor that strikes

17,000 Americans each year.

The venom-derived molecule binds to certain types of living cells. When emitted through the scorpion's stinger, it grabs onto nerve cells, paralyzing the creature's prey. In test tube and animal studies, the synthetic protein binds effectively to glioma cells yet leaves other cells untouched.

Researchers hope that by combining radioactive iodine with this molecule and releasing the mixture in the vicinity of tumor cells, they'll be able to kill the cancer

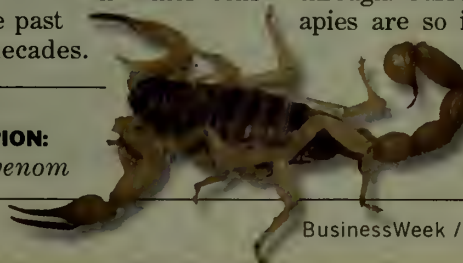
without hurting surrounding tissue. "The venom is the smart bomb, and the radioactive iodine is the payload," says Dr. Adam N. Mamelak, director of neurosurgery at City of Hope National Medical Center in Duarte, Calif., one of two test sites.

Cancer researchers have been developing drugs that can home in on tumor cells for the past two decades.

GIANT SCORPION:
Vital venom

But most targeted therapies are based on antibodies—large molecules that don't travel easily through the brain and can cause adverse side effects. This protein is much smaller, so it travels through the brain more effectively, Mamelak says. If the venom-based drug works in humans, it will be a breakthrough: Current glioma therapies are so ineffective that half of those diagnosed die within a year.

Arlene Weintraub



RESEARCH

A DOWNTURN WELL SPENT

Texas Instruments' R&D engine is humming

The semiconductor industry's past two cyclical slumps were not kind to Texas Instruments Inc. The Dallas company flubbed its planning for the ensuing recoveries—and paid for it with market-share losses. When sales plunged in 1996, TI was preoccupied with finding a leader to replace then-CEO Jerry R. Junkins, who died unexpectedly from a heart attack. Two years later, when demand waned again, TI was in the midst of divesting the bulk of its sprawling empire, including memory chips and defense electronics, so it could focus on products geared to the Internet.

Last year, however, when the industry slid into its steepest decline ever, TI played a much stronger hand. Sensing an opportunity to one-up its rivals, it tapped the \$5 billion-plus in its coffers to buy new equipment and keep research and development humming. Now, it's revving up state-of-the-art production lines to spew out scores of new chips, which could bolster its leadership in digital signal processors (DSPs) and analog chips. Both are vital for products that handle real-world signals, such as digital cameras, MP3 players, voice-activated toys, and other multimedia gadgets. Of all U.S. chip companies, "TI has done the best job of managing this downturn," says UBS Warburg analyst Thomas A. Thornhill III.

There are signs that the gamble is paying off. When TI announces second-quarter results on July 22, analysts are expecting 9.5% growth in revenues, plus \$104 million in income—its first quarterly profit in more than a year. Meanwhile, sales of TI's chips have surged 10% since the beginning of the year, double that of the overall industry.

Yet with demand for most high-tech gear languishing in the doldrums, TI could do everything right and still come up short. Just three months ago, chipmaker stock prices soared when execs began talking about a rebound on the horizon. It turned out to be a mirage. Many chip stocks are now testing 12-month lows. On July 3, Advanced Micro Devices Inc. cut its second-quarter sales projections for the second time in two weeks. More recently, suppliers of chipmaking equipment have also gotten slammed by Wall Street.

So what's buoying TI's sales? Skeptics say it's little more than a temporary uptick in chips for wireless phones as handset manufacturers recover from last year's inventory glut. That's lifting spirits at Qualcomm Inc. and National Semiconductor Corp. as well. But since wireless-phone chips account for only about 10% of industry sales, and most other markets are stagnant, total semiconductor rev-



enues will rise only 3% or less this year, barely topping \$140 billion, according to market researchers. Says Needham & Co. analyst Dan K. Scovel: "This is a year for recovery. This is a year of convalescence."

TI's fans, on the other hand, predict a more fundamental shift. Merrill Lynch & Co. analyst Joseph A. Osha predicts that TI's cash position will swell to \$1 billion over the next 18 months. As one of the world's top 35 chipmakers, TI sees only Intel Corp. throwing off cash. Boasts TI CEO Thomas J. Lee: "We've turned the corner."

The turnaround took some time. Despite its cash hoard, TI wasn't opening its chest when the downturn began—it was beating down costs. In 2001, three aging plants were closed and 2,500 workers laid off. By spring, TI had slashed sales and administrative expenses by 34%. But certain budget areas were shielded from the austerity drive. One was a new fab on TI's Dallas campus that had been put on hold when business went sour before. Even while cutting capital spending by 35%, TI continued pouring money into the Dallas wafer fabrication plant, or fab—a total of \$4.1 billion to finish it and revamp several other facilities.

Those investments could reap dividends, because "companies don't spend money in the downturn gaining market share in the upturn," says William



HIGHER TECH

Texas Instruments plans to outgrow both its rivals and the chip industry by betting megabucks on new technologies. These include:

BIGGER WAFERS Cutting chip costs by moving up to 12-inch wafers

TINIER CIRCUITS Shrinking transistors to 130 nanometers, 700 times thinner than a human hair

COPPER WIRES Replacing aluminum circuits for zippier performance

LOTS OF NEW CHIPS

Unveiling 500 new analog designs this year

**ENGIBOUS:
"WE'VE
TURNED THE
CORNER"**

not a team sport," he says.

Whatever happens across the Pacific, TI needs new products that tickle customers and stimulate demand. That's the mission behind its \$1.5 billion R&D operation, which has produced some 500 new high-performance analog chips to be released this year. They'll be used in digital audio receivers, cable modems, other broadband-network hardware, and handheld computers. Together they should generate more than \$1 billion in sales over the next five years. Meanwhile, TI's hot new DSP chips for next-generation cell phones are fetching twice the price of their predecessors. The company believes they'll account for 50% of wireless revenues by yearend, up from 15% today—and lift gross margins above 50%, vs. the current 35%.

The main short-term concern is the market for chips in wireless handsets, which represent 20% of TI's chip revenues. Engi-

bous is hoping the recovery there has legs. But even if it doesn't, he paints a bright long-term picture. TI's trove of new DSP and analog chips are just what the doctor ordered for anything with images and sound. "These are what will drive electronic wealth over the next decade," Engibous says.

That vision is shared by TI's competitors. Last month, three biggies—Agere Systems, Motorola, and Germany's Infineon Technologies, which has a 12-in. fab—announced plans to collaborate on DSP designs and manufacturing. And with PC growth stalled, Intel also wants to cut in on TI's dominant market shares: 44% of DSPs and 60% of wireless phones. "TI's position is weakening," says Raymond A. Burgess, Motorola Inc.'s

William I. Strauss, president of consultant Forward Concepts Co. in Scottsdale, Ariz., credits TI with grabbing a big head start over its chief rivals: Agere Systems, Analog Devices, and Motorola. What's more, Engibous claims, "a significant number of traditional semiconductor strongholds have opted out" of one or more of these technology upgrades—in particular, Japan's cash-strapped producers.

That's news to the Japanese. Even Roger C. Mathus, a former TI manager and now head of the Semiconductor Industry Assn.'s Asian Office in Tokyo, says Japan's chipmakers are not about to throw in the towel, despite huge capital-spending cuts in recent years. To offset skimpy individual budgets, Japanese com-

VISION Even while closing plants and slashing overhead, Texas Instruments was spending more on cutting-edge chipmaking

panies are banding together in a new round of joint ventures reminiscent of those in the 1970s and '80s, which helped Japan drive many U.S. chipmakers to their knees. The consortiums working on next-generation chip technologies include most of Japan's powerhouses, from Fujitsu and Hitachi to NEC and Toshiba. But TI COO Richard K. Templeton doesn't see a threat: "Technology development is

chief of semiconductor strategy.

Clearly, DSP and analog chips, which are projected to outpace the overall market in coming years, are silicon's hot new poker game. The players are plunking down billion-dollar bets, and the winners may be those few companies with very strong stomachs.

By Andrew Park in Dallas, with Irene M. Kunii in Tokyo

an, president of market-watcher rights Inc. in Scottsdale, Ariz. Last intel CEO Craig R. Barrett made me point. Successful companies, I, don't save their way out of re- is—they spend their way out. Eu- chipmaker STMicroelectronics em- that strategy and jumped from in 1995 to the No.3 spot world- year.

its comeback, TI is counting on han just new capacity. In the sec- quarter, the Dallas fab shipped its ell-phone DSPs produced on 12- licon wafers. Compared with to- ight-inch wafers, the larger plat- ash per-chip manufacturing costs o 40%, because twice as many an be crammed onto each wafer. means TI can undercut the prices ls using eight-inch wafers. More- he new fab can print the smallest tors yet—a mere 130 nanometers or 700 times thinner than a hu- air. These ultratiny transistors re- lower consumption, a major selling among makers of mobile phones her handheld gadgets. Finally, TI ching from aluminum to copper so signals can zip through chips boosting performance.

hardly the only chipmaker adopt- ese new technologies. But Engi- asserts that only an elite group is g all three, including IBM, Intel, n Semiconductor Manufacturing, nited Microelectronics. DSP expert

HOW DOES HARRY DO IT?

Baxter is thriving as CEO Kraemer makes sure he and his employees have plenty of time for family

It's late Tuesday afternoon and, as usual, Harry M. Jansen Kraemer Jr., chairman and chief executive of Baxter International Inc., is awlirl. Since he was named chief executive of the medical-products company in 1999, Baxter has become one of the industry's best and most consistent growth machines, with revenue and operating profit rising by double-digit rates. Its biosciences unit could soon rival Amgen Inc., thanks in part to recent breakthroughs in vaccine technology. And in June, Baxter announced its fifth big acquisition in 16 months, increasing its staff to more than 48,000.

So what exactly is Kraemer busy with? He has just settled his infant son, Daniel, in a portable crib in the kitchen and is now hopping into his car to pick up daughter Shannon, 8, from first-Communion practice. At the church, he bumps into another dad, who is organizing a weekend camping trip that Kraemer has been planning to take with Shannon. Back home, he checks in with his oldest, 14-year-old Suzie, and then takes over from wife Julie in supervising the other two kids—Andrew, 11, and Diane, 4—who are bouncing on a backyard trampoline he bought at Sam's Club. In a moment, Kraemer, 47, is springing into the air, too.

That's right. The chief executive of a \$7.66 billion company is at home on a workday with his family. Want to know something else? He does this a lot. He even tells employees to duck out as often as he does. "Nothing is more important than family," says Kraemer.

At a time when executives are being reprimanded, if not indicted, for putting their own interests first, Kraemer represents a more broad-minded approach to leadership. Certainly, he's not alone. But it's also true that at many companies offering flexible schedules,

the boss doesn't take the idea seriously—which often means employees don't, either. "People follow examples," says Carol Sládek, a work-life consultant at Hewitt Associates LLC, "so when a CEO like Harry Kraemer says, 'This is important to me,' you see a real impact. That definitely is a rarity."

Kraemer believes Corporate America has it backward. By encouraging employees to adjust their schedules to suit their needs—starting later so they can get the kids off to school or working one day a week from home—Baxter can attract and retain top-notch people, he argues. The company also ends up getting more quality time from employees, he adds, because they are less distracted while in the office by tugs from home.

David R. Olson is the kind of employee Kraemer has in mind. Olson, a Web-design engineer, lives in suburban Milwaukee, 50 miles from Baxter's headquarters in Deerfield, Ill. To see more of his wife and their two preschool-age sons, Olson works from home every Friday and every other Thursday. He also is free to juggle that schedule if he needs to. Whenever Olson tells friends about his relaxed work set-up, he says their response is invariably: "Wow, that must be nice." It is. But Olson says he also gets more done working from home since "no one is stopping by your office to chat."

Indeed, Kraemer believes the payback goes beyond good feelings. He points out that since 1993, when he became chief financial officer and began championing work-life balance, Baxter has hit its earnings target every quarter even as it has nearly doubled its profit goal, to a growth rate of 15%. In

2001, the company earned \$612 after a one-time charge of \$156 and its gross margin rose to a 44.8%. Baxter's market capitalization increased more than tenfold, to \$8 billion, during that same 8½-year span.

The company surprised its competitors last fall by winning a million contract, along with junior Acambis PLC, to produce 155 doses of smallpox vaccine. In the quarter, Baxter's profit rose 15% to \$253 million, as sales grew 11%, to \$2.6 billion, even while many rivals fell. Kraemer says investors can expect similar increases into 2003. But even when things come up short, Kraemer says the way he'll abandon the flex-time.

Of course, his family-first philosophy hasn't been responsible for the company's performance. It's his strategy for growth by acquisition that has led to those numbers. Kraemer won't acquire another company, for instance, unless he thinks it will generate a post-tax rate of return of at least 20%. At his direction, Baxter also

HARRY M. JANSEN KRAEMER



BORN January, 1955, New York (Declines to give exact date of birth, citing security concerns.)

EDUCATION B.A., math and science, Lawrence University, 1977; M.B.A., Northwestern's Kellogg School of Management, 1980

FAMILY Married to Julie. They have five children: Suzie, 14; Andrew, 11; Shannon, 8; Diane, 4; and Daniel, five months old

JOBS AT BAXTER Became CFO in 1993; chairman and CEO in 1999; chairman since 2000.

FAVORITE CHORE Chauffeur the kids.

LEAST FAVORITE Cooking.

BEHIND THE NAME Jansen is his wife's maiden name.



COOKIN': Baxter's market cap has risen tenfold since 1993.



heavily in manufacturing facilities, giving it plenty of low-cost capacity to produce genetically engineered enzymes and blood-clotting products, two of the most promising businesses. Kraemer also has hand-picked a talented management team, including Baxter's first chief scientific officer. "It's almost impossible to figure out what the exact formula is to do so well, but clearly, a formula is an effective one," says Robert L. Shoss, a portfolio manager at AIM Management Group Inc., who owns 12.8 million Baxter shares. While proud of Baxter's financial success, Kraemer says his motivation is not just to make the numbers. He wants to do right by his employees, too. His daughter's Catholic whose sister once

thought he might become a priest, Kraemer says: "Yes, we've got a job to do. But we can still operate in a way that's very respectful. We're all struggling. To one degree or another, we're all trying to create that balance."

Kraemer traces his convictions to his father, a retired salesman for CIT Group Inc. The family moved several times as Kraemer was growing up. He says the relocations only strengthened the family bonds. Kraemer says of his father: "His whole focus was the family. I don't think he ever went out without taking at least one or two of us along."

Kraemer's dad also gave his five kids some advice: "Never get full of yourself...you really aren't better than anybody else." Kraemer seems to have tak-

FIRST THINGS FIRST

No work calls after 6 p.m., says the coach of his daughter's softball team

en that to heart. True, like many CEOs, he receives a princely compensation package: a salary and bonus of \$1.6 million, plus options worth \$18.7 million last year. Yet he drives a Toyota Avalon and lives in a relatively modest neighborhood in suburban Chicago. He donates 15% of his income to the Catholic church and charities. About his only splurge is booking the corporate jet every six weeks to fly his family to Minneapolis/St. Paul for the weekend to see the grandparents and cousins. (Baxter pays for the flights, and the amount—\$42,122 last year—is listed in its proxy as other income for Kraemer.)

If employees are still wondering how serious Kraemer is about family time, they should stop by his office after 6 p.m. More often than not, it will be empty: Kraemer has dinner at home about three times a week. He also bars any work-related calls in the evenings so he can coach daughter Suzie's softball team or take everybody to the library without interruption. Then he helps Julie get the kids to bed, goes for his late-night run, and puts in a couple of hours of work. "It's not that he works 40 hours instead of 80," says Julie, a former investment banker at Citibank. "But he chooses his hours so he gets to do the things he wants to do."

Not always, though. Last summer, Kraemer had to break his rules to deal with a crisis when more than 50 people died after undergoing kidney dialysis using a Baxter blood filter. The company yanked the product from the market and then, after tracing the deaths to the use of the wrong rinsing fluid, took an aftertax charge of \$156 million to cover settlements with the victims' families and the shutdown of two plants. As penance, Kraemer cut his 2001 bonus by 40%, or \$500,000, and the bonuses of all other top execs by 20%.

Kraemer's biggest impact could be on other executives. Walter E. Boomer, who became chairman and CEO of Rogers Corp. after commanding the U.S. Marine Corps during the Persian Gulf war, is a director at Baxter. Boomer says he is trying to copy Kraemer's approach at his \$276 million company. "One of the things that Harry shows us," Boomer says, "is that despite a very hectic pace and despite a tremendous amount of responsibility, you can pull it off if you want to." That's a lesson a lot of bosses still need to learn.

By Michael Arndt in Deerfield, Ill.

LENDING

LESS CREDIT WHERE CREDIT IS DUE

After WorldCom, Enron, and the rest, getting a corporate loan will take longer and cost more

Banks have been paring back lending for the past 12 months, and venture-capital money and equity issues have all but dried up. But the collapse of telecom giant WorldCom Inc., coming on the heels of a record number of corporate bankruptcies, threatens to throw the credit markets into a new tailspin.

Institutional investors such as insurance and pension funds now face huge losses from \$32 billion in WorldCom debt. That's on top of \$40 million wiped off the value of WorldCom's equity this year as well as losses from Enron, Kmart, Global Crossing, and others. They swear they aren't going to get stuck again. And, because of the way credit markets now work, that could have a dramatic impact.

In the past decade, banks have moved aggressively to get risk off their balance sheets by packaging loans and selling them to institutional investors. Banks generally keep 10% or less of the stock, loan, or bond they underwrite. "It's a totally different practice from 10 years ago," says Thomas D. McCandless, an analyst at brokerage Keefe, Bruyette & Woods Inc. "Then, the policy was, 'If it's good enough to underwrite, it's good enough to keep.'"

The shift made it much easier for companies to raise money, and helped bankroll the economic boom of the 1990s. Outstanding corporate credit has doubled in the past decade to reach \$4.9 trillion in the first quarter of 2002. All this financial liquidity, though, relies on the willingness of institutions to buy loans, bonds, and stock from banks.

But the recent spate of "fallen angels"—companies that slipped from investment grade to junk at a rapid clip—has opened a rift between the two

groups.

Bondholders argue that banks, which enjoy the cheapest source of funding, need to step up to the plate and take on more risk. "Bankers have special responsibilities, because they have special privileges," says Paul McCulley, managing director of Pacific Investment Management Co. "We need to put some [risk] back onto bank balance sheets. If they don't want to do it, Mr. Greenspan needs to put a shoe in their backsides and make them."

The battle between banks and the institutions is spilling over into the courts. A group of 11 insurers are locked in an ugly legal battle against J.P. Morgan Chase over Mahonia, an Enron Corp. off-balance sheet partnership the bank helped create. The insurers refuse to pay a \$1 billion claim filed by the bank, saying Mahonia was a sham. The bank says these insurers are just trying to shirk their obligations. Off-balance sheet

transactions created by both Citigroup and J.P. Morgan Chase for Enron will be the subject of a Congressional investigation this month. Both banks were big le to the energy concern, underwro bonds, and recommended its stock ron pension funds are also suing th ergy company's bankers.

WorldCom's meltdown has ang the institutions even more. The co



ed a record \$11.8 billion in bonds y, 2001. About half the amount went to pay back short-term bonds. When the company admitted counting fraud and restated five years of earnings in June, banks left with about \$2.7 billion in ex- and bondholders were stuck with billion in debt that now trades at discounts. "There has to be due ce, responsibility, and accounta- by the underwriters," adds Sey- Sternberg, CEO of New York Life nce Co. "Might there be a lawsuit ? If the facts warrant it, you bet."

h J.P. Morgan Chase and Citi- lead underwriters on the World- Com bonds, say they relied on company numbers and couldn't have foreseen the fraud. The bonds were underwritten based on World- Com's 2000 numbers. Its restatement goes back to the start of 2001, though its 1999 and 2000 numbers are now being re- viewed by the Secu- rities & Exchange Commission.

Some politicians are jumping in. "Ob- viously, when you're getting the type of

CHEAP BUT HARD TO GET

Interest rates are at historic lows, yet companies are finding it much tougher to raise cash this year

	FIRST HALF 2001 BILLIONS	FIRST HALF 2002 BILLIONS
BANK LOANS	\$1,095	\$1,019
SYNDICATED LOANS	644	587
INVESTMENT-GRADE BONDS	373	357
JUNK BONDS	60	40
IPOs	24	13
VENTURE CAPITAL*	13	6

*First quarter only

Data: Thomson Financial, Federal Reserve

fees that are generated here and you're not putting a lot of your money at risk, you have to make sure [transactions are] being done properly," says Representative Paul E. Kanjorski (D-Pa). On July 8, he wrote Salomon Smith Barney analyst Jack Grubman, who was close to former WorldCom CEO Bernard J. Ebbers, asking if WorldCom executives had received shares in sought-after initial public offerings underwritten by the Citigroup unit. A Citigroup spokes- woman says the bank is reviewing the request, but adds that no analyst is responsible for IPO allocations.

Despite the WorldCom furor, corpo- rate credit markets aren't going to dry up completely. After all, money man- agers wouldn't be happy with a portfo- lio comprised entirely of Treasury bills. And some controversial big names are still getting bank loans. For instance, AOL Time Warner Inc. secured a \$10 billion line of credit on July 8, replacing loans that come due in the fall.

All the same, companies hoping to raise money in any shape or form in the next six months had better be ready to be poked, prodded, and cross-examined—and pay up for the privilege. Lenders, investors, and bondholders alike are treating all num- bers they're given by debtors with sus- picion. The increased scrutiny of existing

Companies hoping to raise money will be poked, prodded, and examined head to toe

companies could have a twofold effect, experts say. "For companies that are actually doing poorly, their decline will be accelerated," says Jonathan Schiff, a professor of accounting at Fairleigh Dickinson University and president of Schiff Consulting Group. "Those that are actually doing well will prosper."

Any company that relies as World- Com did on EBITDA, or earnings before interest, tax, depreciation, and amorti- zation, is now under the magnifying glass. The measure, once considered a fair judge of cash flow, was easily ma- nipulated by WorldCom. But even be- fore the WorldCom fraud was revealed, not everyone was a fan. In February, CEO Warren E. Buffett told Berkshire Hathaway Inc. shareholders in his an- nual letter: "References to EBITDA make us shudder—does management think the tooth fairy pays for capital expen- ditures?" Still, EBITDA was used routine- ly in media, hotels, and gaming, as well as telecom. Now, bankers and investors are reevaluating most such companies.

Also on the line: the swashbuckling CEO. Jokes one banker: "We're not lend- ing to any company whose CEO is known by their first name." After the recent problems faced by Bernie [Ebbers], Martha [Stewart], and Dennis [Koz- lowski], the appeal of a low-key, down- to-earth CEO seems obvious. Bond guru William H. Gross, managing director of Pacific Investment Management, says in his most recent newsletter: "We're shunning corporations whose CEOs are the cover boys and cover girls at book- store magazine stands...[and] manage- ment that's paid themselves tens of mil- lions per year. We're looking for common sense, not star worship."

Companies with grounded manage- ment and straightforward numbers aren't off the hook if they want to raise funds. "You'll see lenders doing more audits themselves," says Michael Lough- lin, chief credit officer for commercial banking at Wells Fargo Co. His bank plans to hire outside auditors to exam- ine numbers from companies that aren't existing customers—probably passing the costs along to borrowers. Wary bond buyers have the same idea. New York insurer American International Group has set up a new risk-management group independent of its investment de- partment to review all of its large trans- actions. "We'll have an additional set of eyes" looking at investments, says AIG CEO Maurice R. "Hank" Greenberg.

As WorldCom teeters, there isn't a part of the credit market that isn't touched by the fallout from its woes. Even healthy companies that want to borrow are likely to suffer from the contagion for months to come.

By Heather Timmons in New York

COMMENTARY

By Mara Der Hovanesian

DON'T BOTHER CALLING THE HEDGE-FUND COPS

If the Securities & Exchange Commission had any doubts about what it faces in taking on the \$500 billion hedge-fund industry, it need look no further than New York. In June, industry lobbyists deftly carved an exemption from a new state law on investment advisers that could have forced some hedge funds to disclose their inner workings, such as trading strategies. The threat to up and leave the state from which the bulk of hedge-fund managers operate was the clincher.

It's not the first time would-be regulators have buckled under pressure. After the 1998 blowup of Long-Term Capital Management, Washington railed against hedge funds' reckless use of borrowing against assets and their secretive nature. Designed to rein in hedge funds, the Derivatives Market Reform Act and The Hedge Fund Disclosure Act were bandied about in 1999, but died in Congressional committees the next year.

Now, the SEC is on the prowl again. In late May, Chairman Harvey L. Pitt announced the agency would investigate managers who pump up their performance, double as mutual-fund managers creating potential conflicts of interest, and use questionable tactics to market to unsophisticated investors. Until recently, most investors had to pony up at least \$1 million to buy into a hedge fund. These days, the minimums are much lower, and that has regulators worried about the welfare of small investors. Pitt is worried about a "seismic boom" in assets: Hedge funds attracted a record \$31 billion in 2001, and analysts expect the industry will top \$1 trillion by 2004.

Investment pros such as William H. Gross, managing director of institutional money manager Pacific Invest-

ment Management Co., have joined the chorus of reprobation. On July 9, the respected bond guru slammed hedge funds for roiling markets by their "willingness to play fast and loose with the solvency of struggling companies."

Hedge funds—unregistered, private limited partnerships—are subject to the antifraud provisions of

Nor are they likely to get one time soon. Observers say the SEC operating with a so-called private der of investigation. This rarely-used device is designed to facilitate finding missions to help shape recommendations, rather than to catch rogues. However, the SEC is allowed to subpoena documents and witnesses—a big plus in the secretive world of hedge

funds—though officials have to know where to look and whom to ask.

So far, the investigation amounts to a fishing expedition in a pool of some 6,000 funds. "The SEC's proach is scattershot; they have to be told about potential problems first," says Sheehan. "They don't to just march in and look around." The SEC will comment on its probe.

Billion-dollar funds are the likely first targets. But the most egregious problems tend to be among startup funds run by inexperienced managers. Taxed for resources, the SEC's success in turning up small-time scams doesn't look good. "The SEC spends most of its time reacting to complaints, let alone trying to stop scams before or as they're happening," says Thomas Fedorek, senior managing director of Citigate Global Intelligence

Security, an investigative firm.

For now, simple background checks of managers—which often turn up prior felony convictions or run-ins with securities regulators—offer investors who are willing to pay for them more protection than the SEC can. That won't change until Congress legislates tough rules governing hedge funds or brings them within the scope of the 1940 law—both distant prospects for now. In the meantime, it's buyer beware.

Der Hovanesian covers markets



WHY THE SEC'S HEDGE-FUND CAMPAIGN FACES TOUGH GOING

- Both federal and state efforts to regulate funds have been thwarted by the industry's powerful lobby
- The SEC lacks the authority to investigate hedge-fund investments and managers
- Investor complaints, the agency's main source of leads, have been few and far between
- With limited resources, the SEC is struggling to handle its current caseload

federal securities laws, but they aren't regulated by the Investment Company Act of 1940. Mutual funds, on the other hand, must register with the SEC and are subject to rigorous inspection. That means the SEC must rely on disgruntled investors and whistle-blowers for information about hedge-fund shenanigans. "It's not as if the SEC is asleep at the switch," says Margaret Sheehan, partner at Washington (D.C.)'s Alston & Bird LLP, which specializes in securities law. "They don't have a switch, or at least not much of one."



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QUALITY ISN'T JUST FOR WIDGETS

Six Sigma, the quality-control and cost-cutting power tool, is proving its worth on the service side

In the world of manufacturing, Six Sigma has become something akin to a religion, with none other than John F. Welch as its charismatic apostle. The former chairman and CEO of General Electric Co. came late to this rigorous, statistical approach to quality control. But once he embraced it in 1996, he quickly assembled an unprecedented army of employees to pinpoint and fix problems throughout GE using the number-crunching skills they learned in Six Sigma training. The results were awesome: In the past three years alone, these troops saved the company \$8 billion, according to GE. Little wonder, then, that Welch has won so many converts preaching the cost-cutting power of this methodology.

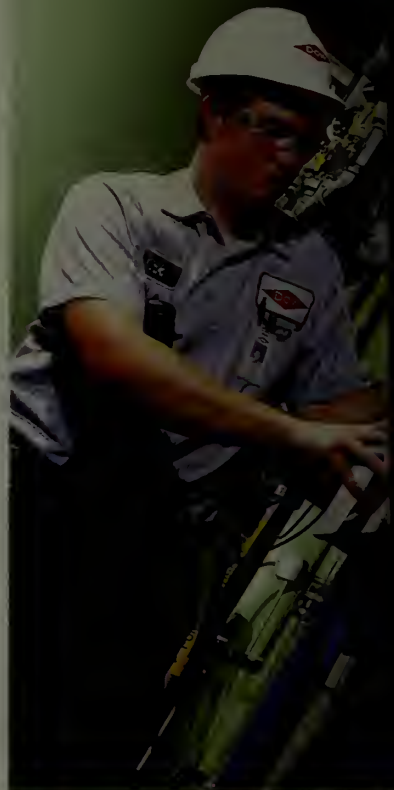
So what is GE doing with Six Sigma under Welch's successor, Jeffrey R. Immelt? More than ever. The \$125.9 billion conglomerate is spending \$600 million on Six Sigma projects in 2002—mostly for the salaries of 4,000 full-time Six Sigma experts, plus 100,000 employees who've undergone basic training. Altogether, they have a target of finding an additional \$2.5 billion in savings in the Fairfield (Conn.) company. On top of that, GE is sending out its Six Sigma squads to customers such as Dell Computer and Wal-Mart Stores to help them root out what GE estimates to be more than \$1 billion in inefficiencies and waste—and help GE win more business.

GE may be preeminent, but it's certainly not unique in pushing Six Sigma into new corners of its business. Originally conceived by Motorola Inc. as a quality-improvement device in the mid-1980s, Six Sigma soon morphed into a cost-cutting utensil for manufacturers of all stripes. Now, it's fast becoming the Swiss army knife of the business world. Goods producers still make up the bulk

of users, who typically rely on statistics to uncover and then reduce product variance in order to boost quality and efficiency (table). But increasingly, manufacturers are applying Six Sigma to functions as varied as accounts receivable, sales, and research and development. And their success in these non-factory domains has inspired Six Sigma projects at financial institutions, retailers, health-care concerns, and in other areas of the service sector. Says Gregory H. Watson, a consultant and past president of the American Society for Quality in Milwaukee: "Six Sigma might be the maturation of everything we've learned over the last 100 years about quality."

It's easy to see why Six Sigma works well in large-scale manufacturing. For one, factory processes tend to be both repetitive and easy to track as goods move along the line. Also, companies usually quantify what happens at each step. So, by measuring defects per output, they can quickly assess how a different way of doing things at any stage affects productivity or profits.

Generally the gains add up swiftly as Six Sigma squads discover ways to reduce personnel, capital spending, or overhead. Bosses can then redeploy staff or take the gain to the bottom line. At Dow Chemical Co., for instance, each Six Sigma project has freed up an av-



THE SPREAD OF SIX SIGMA

Dow Chemical, which has saved \$750 million with the system, applies it to back-office functions

erage of \$500,000 in the first year. In one case, the discovery that aging materials enabled Dow to eliminate defective items on that line by itself. Managers claim that in total, such improvements have saved the co-

WHERE PRECISION IS LIFE OR DEATH

A year ago, it took Wellmark Inc. 65 days or more to add a new doctor to its Blue Cross & Blue Shield Assn. medical plans. Today, despite working with a reduced staff, the Des Moines managed-care company gets the job done in 30 days at most. The staff cuts, meanwhile, have helped the company shave administrative expenses by \$3 million per year, enabling it to keep a lid on premiums.

Wellmark's secret? Six Sigma, the factory-floor methodology spreading

quickly through the service sector. An analytical tool helped Wellmark employees discover that doctor referrals often got stuck as procedures were double-checked one another's work of sending the forms along for approval. O.K. All told, they concluded the process was redundant. Now unnecessary steps are gone. "We've been successful if it has been as usual," observes John Forsyth, Wellmark's chairman. Together with the likes of

THE NUTS AND BOLTS OF SIX SIGMA

WHAT IS IT?

An analytical method aimed at achieving **NEAR-PERFECT RESULTS** on a production line. In statistics, the Greek letter sigma denotes variation in a standard bell curve. One sigma equals 690,000 defects per 1 million. Most companies do no better than three sigma, or 66,000 errors per million. Six Sigma reduces that count to **3.4 DEFECTS PER MILLION**. That saves money by preventing waste.

sales reps in 3M's orthodontic-products division to identify exactly why its top agents sold so much more than others. And it doesn't stop there. By judging how well employees run fix-it projects, company leaders are hoping to spot their successors. "Six Sigma is about developing tomorrow's managers," says Chairman and CEO W. James McNerney Jr. "It gives them a shot to show what they can do."

Six Sigma isn't a cure-all, to be sure. In the first few months of a project, up-front training costs always outweigh any savings. And through the life of the project, the expense of compiling and analyzing data may also exceed what is saved, particularly in areas where a process cannot be easily standardized. Even GE, which does thousands of Six Sigma projects a year, concedes it hasn't yet made much headway in applying Six Sigma to its legal operations. Companies also stand to lose if top management doesn't buy into the program and implement the fixes recommended by its top Six Sigma analysts, known as "black belts."

But that said, GE is still pushing the

HOW DOES IT WORK?

The tool achieves results by reducing subjective errors in the assessment of problems. First, auditors **DEFINE** a process where results are subpar. Then they **MEASURE** the process to determine current performance, **ANALYZE** this information to pinpoint where things are going wrong, and **IMPROVE** the process and eliminate the error. Last, **CONTROLS** are set up to prevent future bugs.

envelope. Its GE Capital subsidiary recently dispatched a couple of black belts to Dell Computer Corp.'s headquarters in Round Rock, Tex., to analyze its accounts-payable process. After mapping the procedure step by step, they discovered that Dell was getting buried in paper invoices because its just-in-time manufacturing operations required that the company purchase some types of parts as often as 12 times a day. To solve the problem, the GE Capital team moved Dell from its slowpoke manual system to an Internet-based electronic filing setup. Estimated savings: \$2.4 million a year.

Although Dell pockets the cash, GE can come out ahead, too. If GE customers are more productive and profitable, GE wagers that the goodwill generated through Six Sigma advice will translate directly into contracts. "When you think about GE Capital at the end of the day, we lend money. So do a lot of other people," notes Margaret Keane, chief quality officer at GE Capital. "This is really a way to differentiate us." Jack Welch may have moved on. But to more and more companies, Six Sigma is gospel.

*By Michael Arndt
in Chicago*



GOOD MEDICINE

Cathy Buck oversees Six Sigma operations at Froedtert

results to 23 minutes, from 52. Based on such results, Buck eagerly advises other health-care managers to start

Six Sigma programs. It's turning out to be a smart prescription for the services sector as a whole.

By Michael Arndt

than \$750 million since 1999. Increasingly, however, manufacturers are picking up their biggest savings far from the factory floor. Dow Chemical, for example, projects it will save another \$750 million by the end of next year if it applies Six Sigma to such areas as procurement and sales. And Six Sigma experts at 3M Co. have employed the methodology to reduce inventories and speed up R&D efforts at the company's St. Paul (Minn.) headquarters. One team even analyzed the performance of

an Express Co., Wellmark is now a breed of service company applying Six Sigma to debug operations. And nowhere does it show more promise than in the health-care sector. After double-digit price hikes, the industry is under enormous pressure to cut costs. At the same time, doctors are on a quality kick after studies highlighted how health-care personnel may be injuring or harming thousands of patients annually by giving them the wrong medications. Froedtert Hospital in Milwaukee is no exception. Two years ago, it put

its first two employees through training. Along with two other so-called black belts, they've so far completed a dozen projects. Today, their boss, COO Cathy Buck, effectively doubles as a Six Sigma consultant. She rattles off success stories, like how the 655-bed hospital has had only one incident of a patient being wrongly medicated since standardizing its intravenous-drug practices. Or how it slashed its turnaround on intensive-care-unit lab

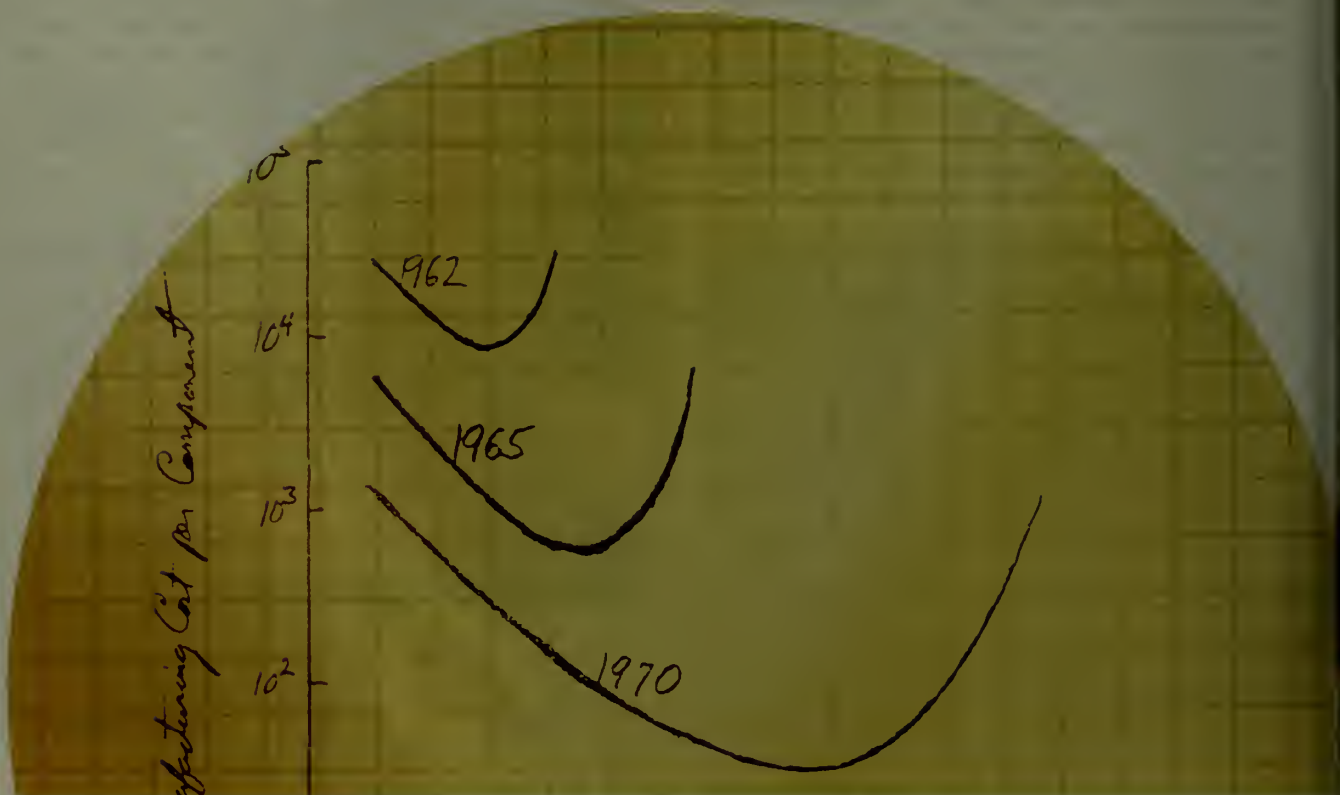
Will Moore's Law stand forever?

In 1965, Intel's Gordon Moore created a "law" that became shorthand for the rapid, unprecedented growth of technology. He predicted that the number of transistors on a chip would grow exponentially with each passing year.

At the time, even Gordon never imagined it might still be true today.

But Intel has developed new technologies that will allow us to squeeze one billion transistors on a chip (a far cry from the 2,300 on our first processor).

Gordon Moore sketched out the amazing pace of silicon technology development in 1965. His "law" remains valid today.





This wafer represents Moore's Law at work. The Intel® Itanium® 2 processors here hold over 220 million transistors each.

**This isn't science for science's sake.
It's science for your
company's sake. Because as we work
to fulfill Moore's Law, year
after year, companies everywhere can
do more at lower cost.
And that's not just a good law.
It's very good business.**



Sophisticated tools perform tests to ensure the highest-quality processor.



Processor production, constantly monitored by smart machines and smart people.



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CAN BIG PHARMA CURE ITS LEGAL MIGRAINES?

A wide-ranging assault may force the industry to change the way it does business

COMMENTARY

By Amy Barrett

Criminal investigations, multistate assaults by attorneys general, circling class-action lawyers, corporate whistle-blowers, industry-reform legislation, op-ed indignation. Sound like a rehash of the legal woes that once haunted the tobacco industry? Nope. These are the current headaches facing the companies that probably do the most to improve people's health: drug manufacturers.

While Big Pharma isn't receiving quite as much bad publicity as other besieged industries, such as accounting or tobacco, it is facing an equally wide-ranging legal and regulatory onslaught. The recent wave of private and government litigation against drugmakers targets nearly every major player in the industry, including Merck, Johnson & Johnson, Bristol-Myers Squibb, Pfizer, and GlaxoSmithKline. Coming under attack are some of the basic business practices that have helped fuel the industry's growth (table).

The assault will, at a minimum, cost the industry big bucks in defense fees—and perhaps damages awards. The announcement on July 9 that Wyeth's hormone replacement therapy product Prempro raises the risk of breast cancer and heart disease, for instance, may well trigger a race to the courthouse. But the greater worry for pharmaceutical executives is that the growing vilification of the industry could force them to change the way they sell drugs—and possibly give momentum to legislation and regulation aimed at squeezing drug prices. The legal attacks "further demonize the industry," warns Pfizer Inc. Chairman Henry A. (Hank) McKinnell, who worries that Big Pharma's image problem could lead to tough new laws. "If we are seen as part of the problem, we'll be dealt with as a problem."

How did the once blue-chip industry get in such a mess? In many ways, the

drugmakers are victims of their own success. In the 1990s, they became heroes on Wall Street by consistently delivering double-digit earnings growth. But the fierce competition to keep making the numbers prompted some players to test the legal boundaries when it came to promoting products. Compounding the pressure: the proliferation of me-too drugs that force companies to rely on aggressive sales ploys rather than science to grab market share.

Unfortunately, the cutthroat tactics spread like a virus. "If your competitors are pushing the envelope, it is very difficult to compete with that," says Dr. Joseph Gerstein, pharmacy strategy consultant at Tufts Health Plan, who was a whistle-blower in a recently settled case against TAP Pharmaceutical Products Inc. The result, he says, is that overly aggressive players "push everyone in that direction."

While Wall Street applauded the industry's performance, insurers, consumers, and the government—those footing the fast-growing drug tab—began to howl about increased bills. In response, Big Pharma hired armies of lobbyists to kill any moves to rein in drug costs. The current legal backlash is the inevitable fallout from the drug industry's refusal to address the mounting cost problem. "The greed has run amok,"

declares Congressman Pete St. (Calif.). "They're going to end up a serious revolt on their hands."

Indeed, the rebellion already has a gun. Players are being held up to new standards, and some industry practices that have been commonplace for decades suddenly are being treated as outrageous. Take, for example, the reimbursement of some drugs under Medicare and Medicaid. In lawsuits filed early this year by the state attorneys general of Nevada and Montana, a long list of drugmakers, including Pharmacia and GlaxoSmithKline PLC, is all but forced to have reported inflated prices to the government reimbursement programs. The suits charge that inflated prices win market share by selling the drugs at discounts to the government. (The cases primarily concern drugs such as cancer therapies that are administered directly by physicians.) The suits charge that inflated reimbursement prices win market share since doctors favor drugs that they can pocket the spread between their price and the price at which the government reimburses. Spokesmen for Glaxo and Pharmacia say that their pricing practices are legal.

But while the discrepancy between the reimbursement prices and market prices has been known for years, it only recently became a major legal issue. That's no surprise.

UNDER SIEGE

The drug industry is under attack by the Justice Dept., the FTC, state attorneys general, and trial lawyers for a wide variety of controversial tactics.

AGGRESSIVE MARKETING

A former employee of Warner-Lambert, now owned by Pfizer, alleges the company promoted its epilepsy drug for unapproved uses. The U.S. Attorney's office in Boston has subpoenaed former Warner employees to testify before a grand jury. Pfizer is cooperating with the inquiry and says that the issue arose before the merger.

BLOCKING CHEAP GENERICS

The FTC is investigating whether companies with profitable brands properly attempted to slow down competitors—thereby keeping prices artificially high and harming consumers. More than two dozen states have filed suits against Bristol-Myers Squibb, alleging the company illegally delayed rivals to drug Taxol and the anti-anxiety drug BuSpar. Bristol declined to comment.

total state
ts are expected
e 6.6% for fiscal
2002, while state
caid bills for pre-
ion drugs are ris-
bout 18% a year, ac-
ng to the National
iation of State Bud-
Officers. And while
companies argue that
ription drugs will keep
n-care costs down in the
run—for example, by re-
g hospital stays—that is
consolation to states fac-
udget deficits now.

gnifying the legal worries is a new
f whistle-blowers throughout the
ry. A former Warner-Lambert Co.
yee has sued the company, now
d by Pfizer Inc., alleging that
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Medco Health Solu-
t Inc., has disclosed that
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er suits in 2000, alleging,
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switching of people from one
to another. The company says
ograms have complied with the
Adding to Merck's woes is
ongoing controversy over
o's aggressive accounting
ces. "Once you start look-
an industry, the whistle-
ers come out of the
work," says James G.
han, assistant U.S. At-
y in Philadelphia. His of-
e investigating, among

LING

plaintiffs' lawyers
d GlaxoSmith
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AWP) for their
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other things, whether
marketing programs
aimed at managed-care
companies violate anti-
kickback laws.

The whistle-blowers are
producing a steady stream of
negative news stories and pro-
viding the industry's enemies
with plenty of cannon fodder.
That in turn could make it easier
to attack some of the drugmak-
ers' most controversial practices. Con-
sider, for example, the heavy-handed le-
gal attacks companies have used to delay
rival products from generic drugmak-
ers, such as barraging them with seem-
ingly frivolous patent-infringement
claims. Such stratagems have landed
companies such as Bristol-Myers Squibb
Co. in hot water. More than two dozen
states are suing the company for al-
leged antitrust violations in delay-
ing generic versions of the cancer
drug Taxol and the anti-anxi-
ety drug BuSpar. A Bristol-
Myers spokesman says the
company doesn't comment
on pending litigation.

With congressional elec-
tions coming, the drug
industry is a prime politi-
cal target. At the
state level, Michigan
and Maine, among others,
have passed laws aimed at
bringing drug costs down.
Meanwhile, legislation to
limit some patent-extension
strategies has picked up
steam in Washington.

There's little doubt the drug
industry is beginning to respond
to its mounting image problem. A
number of companies have recently
rolled out programs aimed at providing
discounts to low-income consumers.
And in April, a trade group adopted a
new set of guidelines to halt the ex-
travagant dinners and other gifts sales
reps often give to doctors. That's a
start. But with new scandals surfacing
regularly, drugmakers may find those
moves are too little, too late to heal
their damaged reputations.

With Lorraine Woellert in Washington

POSSIBLE KICKBACKS

The Justice Dept. is
probing whether
marketing subsidies that
Schering-Plough offered to
managed-care companies
violated Medicaid rules
or amounted to illegal
kickbacks. The company
is cooperating with the
investigation.

welcome

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OHIO IS THE E CORRIDOR. HERE YOU'LL FIND COMPANIES AND PEOPLE ON THE LEADING EDGE OF ELECTRONIC TECHNOLOGY. IN OHIO YOU'LL ALSO FIND "E" REPRESENTS ALL THE ELEMENTS BUSINESSES NEED TO SUCCEED — ENTREPRENEURIAL SUPPORT, EMPLOYEE ACCESS AND EXPERTISE IN A DIVERSE ECONOMY. OHIO'S E CORRIDOR IS OPEN FOR BUSINESS. ENTER AND PROCEED WITH OPTIMISM.

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BusinessWeek

Investor

MAKING LIFE RICHER

A person is holding a large, ornate menu that reads "THE APPETITE FOR RESTAURANT STOCKS". The menu is framed with a decorative border and features a central illustration of a swan. The person's face is partially visible behind the menu.

THE APPETITE FOR
**RESTAURANT
STOCKS**

■ One Man's
Mortgage Quest

■ A Guide to
Microbrews

■ Barker: The
Biggest Grizzly

'A Clean, Simple Cash Business'

Investors can find tasty plays in casual restaurant chains



BY DEAN FOUST

Inside the Cusi restaurant in Arlington, Va., with its muted brown tones, high-backed booths, and sultry mood music, Oscar Padilla settles in with his notebook PC and one of the chain's signature square bagels. Padilla, a 38-year-old Web consultant, often eats there three times a week. "I hang out in the morning with my notebook and have thinking time, then invite clients for lunch meetings," he says. Padilla, who was burned on tech stocks, may buy Cusi's stock when it goes public in late July.

With tech and telecom in continued free fall, chastened investors such as Padilla are seeking refuge in restaurants. Thanks to strong runups in such companies as Lone Star Steakhouse & Saloon, Panera Bread, and Wendy's International, the 27 stocks in the Standard & Poor's restaurant index have risen 16.9% over the past year and 8.7% annually since 1997. By contrast, the S&P 500 has plunged 18.9% in the past year, and is up an average 3.7% over the past five years. That performance is fueling a revival in restaurant IPOs, with trendy private chains such as Cusi and Red Robin rushing to go public. Why? After a brief pullback in dining out after September 11, consumers have returned in droves, prompting Technomic, a Chicago consulting firm, to raise their 2002 industry-sales-growth estimate to 4.3%—up from 2% in January. "The

truth is, we're a generation that doesn't know how to cook or doesn't have the time to," says Andrew Barish, a restaurant analyst at Banc of America Securities.

What's more, the industry fundamentals are improving. The overbuilding of the mid-1990s when the number of outlets grew an average 10% each year—has abated as lenders have tightened credit. In addition, labor shortages that drove the industry to hike pay an average 6% in the late '90s have eased, with wages on rise just 2% this year. "The quality of the industry is getting better, which reduces turnaround

training," says Lynch analyst Peter

Against that backdrop, analysts believe there's more upside. Barish estimates the industry still trades at just 17 times consensus estimated earnings for 2003 and 15 times projected profits for 2003. (By contrast, S&P 500 stock trades at 20 times projected



OLIVE GARDEN: Tuscan-inspired treats

earnings and 18 times next year's earnings. Restaurants can deliver tech-style growth again, you don't need a computer-science degree to understand their business," says Allan Hickok, who follows the industry at U.S. Bancorp Piper Jaffray.

Still, restaurants are vulnerable to changing consumer tastes and razor-thin margins.



And he applauds Applebee's long-running TV campaign that promotes special dishes, such as fajitas. It gets across the message that the menu is constantly being updated.

Barish believes there's opportunity ahead for both Sonic Restaurants, a 1950s-style drive-in chain complete with carhops, and Yum! Brands, the PepsiCo spin-off that

If the credit crunch persists, chains that can fund expansion out of profits, such as Darden and Applebee's, should gain market share on weaker rivals

a spate of lawsuits alleging that major chains have forced managers to work unpaid overtime—which a few, including Shoney's and Starbucks, have settled without admitting guilt—could lead to higher

costs and put pressure on margins. Given challenges of managing growth in this sector, analysts vote against chasing highfliers such as P.F. Chang's China Bistro, and Cheese Factory, which trade at more than 40 times 2002 earnings. "Investors have priced in growth for each of the next three years for stocks. This is too tough a business to do," says Jay Burnham, an analyst at New Edge fund Rocker Partners. And there is a runup may have played out, given that the industry traded at a 12 p/e in the late 1990s.

Street pros also caution investors about going willy-nilly into IPOs. Harry Milling, a senior analyst at Chicago researcher Morningstar, advises against buying New York-based sandwich chain known for its flat, fresh-bread. He notes that its 68 mostly East Coast outlets aren't generating positive cash flow: It recorded a \$42 million loss in 2001 on sales of \$1.1 billion due to the cost of opening new units, poorly performing ones, and absorbing its share of the Xando coffee chain. Così warns in its prospectus that it can operate only until late 2003 without the IPO. "I don't want to invest in a company that says, 'If we don't pull off this, we're gone in a year or we have to make changes to our business plan,'" Milling says.

Meanwhile, the best bets may lie in casual dining chains such as Brinker International, Darden Restaurants, and Applebee's International, which all operate most of their restaurants. With checks below \$20, they have benefited from the trend among consumers to spend less. If the current credit crunch persists, analysts believe that chains that can fund expansion out of profits, such as Darden and Applebee's, should gain market share on weaker rivals.

Applebee's favorite play is Applebee's, whose stock have soared tenfold over the past decade. At \$22, it is trading at just 15 times this year's projected earnings of \$1.43 per share—a premium to its projected five-year growth rate. He believes sales will accelerate once its casual sit-down units add take-out service.

owns Pizza Hut, Taco Bell, and KFC. He says Yum's success at co-branding—putting a Pizza Hut under the same roof as a Taco Bell—saves on real estate costs and boosts traffic by providing choices for groups with divergent tastes. The result: Same-store sales have risen 8% this year at Taco Bell and 4% at KFC. But Barish believes the real play is Yum's international business, which contributes one-third of pretax profits and is still growing better than 15% a year. "They're where McDonald's was 10 to 15 years ago," he says.

For investors with an appetite for turnarounds, Burnham suggests Rubio's Restaurants, which operates roughly 140 Mexican eateries on the West Coast. After two years of flat sales, it last year shut 11 outlets and redesigned its remaining units by putting grills and see-through refrigerators out front to reinforce its focus on freshness. Burnham says at its current share price of \$9, Rubio's is valued at \$500,000 per unit—a third of the \$1.5 million Wendy's just paid for each of 169 Baja Fresh Mexican Grill outlets. "Baja Fresh still has better [financials], but Rubio's is closing the gap," he notes. As a result, Burnham is betting that Rubio's could be worth \$20 to \$30 a share. If he's right, the best investments may be on the plate in front of you. *With Brian Grow*

Dining for Dollars

COMPANY/SYMBOL	PRICE (\$) *	P-E RATIO**
APPLEBEE'S APPB	21.80	15
Constant promotions and menu changes help the chain avoid the staleness that besets some rivals		
BRINKER INTERNATIONAL EAT	31.35	19
With its broad portfolio—Chili's Grill & Bar, Romano's Macaroni Grill, and seven others—the chain bills itself as the "mutual fund of casual dining"		
DARDEN DRI	22.57	15
Marketing Olive Garden as a "Tuscan kitchen" is driving double-digit sales gains		
RUBIO'S RESTAURANTS RUBO	8.56	35
West Coast Mexican chain is in the throes of a turnaround		
SONIC SONC	30.84	27
New breakfast hours should provide an immediate 10% to 15% sales boost		
YUM! BRANDS YUM	28.40	15
Aggressive European expansion provides a great play on the falling dollar		

* July 8

**Based on estimated 2002 earnings

Data: *BusinessWeek*, Bloomberg Financial Markets

Microbrews With Macro Taste

Where to find America's best local beers

BY GERRY
KHHERMOUCH

Road warriors beset by the stresses of traveling should not overlook one dividend of the peripatetic lifestyle: the opportunity to sample some extraordinary American beers. Wherever your business takes you, you can count on finding thriving regional microbreweries and local brewpubs that offer high-quality, inventive takes on classic brewing styles.

These are not the gimmicky or cough-syrupy concoctions that discredited much of the craft-beer industry in the mid-1990s. Today's offerings adhere to brewing science yet can be deliciously unconventional. No surprise, then, that brands go out into the world under names such as Raspberry Leghumper (from Thirsty Dog Brewing in Canton, Ohio), Slam Dunkel (Great Basin Brewing, Sparks, Nev.), and Shark Bite Red (Pizza Port, Carlsbad, Calif.)—and win medals at prestigious gatherings such as the Great American Beer Festival in Denver. (The 21st annual installment of beer heaven returns this year Oct. 3-5; for details, go to beertown.org/GABF/index.htm.)

This new golden age of craft brewing is a throwback to nearly a century ago, before the lion's share of the U.S. beer market consolidated around a handful of bland national lagers. "In any part of the country, there used to be dozens of regional, independent breweries, because beer could travel only so far," says Tom Dalldorf, publisher of *Celebrator Beer News*, a "brewspaper" based in San Leandro, Calif. "Now we're back to an exciting time when flavor and character and diversity of style are avail-

able all over the country. But with few craft brewers willing to go nationwide, you usually have to travel close to the source to sample those brews.

For newbies, where to begin? For easily accessible descriptions of styles, from abbe to zwickelbier (table), visit the Web site of missionary Michael Peterson, beerhunter.com/styles.html. For the up-to-date guide to what's available at your destination, grab the local brewspaper. You'll usually find a stack of a first good beer haven you hit, under names such as *Ale Street News* (East Coast and South) and *Yankee Brew News* (New England).

Most of all, keep an open mind: Cloudfest hefeweizen beers with comet tails of sweet yeast or pitch-black Russian imperial porters sure don't look like Bud or Miller Lite, but almost always taste a whole lot better. Brewpubs offer sampler trays, with 4- or 5-ounce servings of each of the pub's beers. It's a good way to learn about different styles and determine where your preferences lie.

Beer geeks, of course, are always happy to share their obsessions, and this one is no exception. My favorites? Quite a few are available

Beer Geek Speak

ABBEY ALE Strong, bottle-conditioned beers developed by Trappist monks in Belgium and Holland.

BOCK Strong, malty, medium- to full-bodied lagers, often brewed as a spring seasonal offering.

BROWN ALE British style dark- or reddish-brown ale, with a considerably hoppier offshoot pioneered by American craft brewers.

BARLEY WINE Extra-strong ale that can be up to 10% alcohol by volume or more.

BITTER English term for a well-hopped ale; U.S. craft brewers, particularly in the Northwest, love to pour even more hops into pungent "extra special bitters (ESBs)," at about

5.5% alcohol by volume.

HEFEWEIZEN Lighter-bodied beers brewed from wheat as well as barley, popular in the U.S. as a refreshing, aromatic summer beer.



the nation's craft-beer mecca, the Pacific Northwest. Near the top of my list is Juneau-based Alaskan Brewing, whose biggest market is Seattle. Its Alaskan Amber is a perennial award-winner, but my favorite is Smoked Porter, with a distinctive character that comes from having a hunk of salmon smoker treat some of the malt's smoke from alder-wood fires.

Then there's Mac and Jack's African Amber, launched in 1995 by Malcolm Rankin and Jack Harrop, who brewed in a garage at night and peddled out of an ancient Chevy truck by day. It's noteworthy for a spicy aroma that comes from "dry-hopping" the beer in the keg—essentially giving it an extra dose of beer's key bittering agent. (In case you're wondering, the name Mac and Jack was a brainchild of patrons of a Seattle tavern located near the Woodland Park Zoo.) Deschutes Brewing of Bend, Ore., stakes its claim to distinction on an uncommonly smooth Black Butte Porter, a dark, rich brew named for baggage handlers who quaffed it in 18th-century England. Deschutes also offers tawny-colored Mirror Pond Pale Ale, brewed with bushels of the region's Cascade hops.

While Seattle, Portland, Denver, Northern California, and Boston all support a high-profile craft culture, the Midwest, building on its rich brewing heritage, has more than its share of spectacular offerings. A bunch of my favorites hail from there. Boulevard Brewing, of Kansas City, Mo., makes a tasty Pale Ale,

brewed with caramel malt, and a cool, citrus-like Unfiltered Wheat Beer made from Missouri-grown grain. Another standout brewer is diminutive New Glarus Brewing, from a Wisconsin town of that name. It's most admired for delicious cherry and raspberry-infused fruit beers. But I also love its Spotted Cow, a "cask-conditioned" ale in which the flavor is enhanced by allowing the yeast to keep working in the bottle, and Uff-da, a mahogany-colored bock with yummy chocolatey overtones. (The name, a Norwegian expletive, was meant as a good-natured stick in the eye to the town's Swiss heritage.)

My hometown, New York? Sadly, the Big Apple has not proved to be an epicenter of brewing innovation. But Brooklyn Brewing is an exception, with its hearty Brooklyn Lager, hoppy East India Pale Ale, and mild Pennant Pale Ale (heralding the 1955 World Series championship brought home by the Brooklyn Dodgers). In the New York area, it's also easy to find exquisite Belgian-style ales brewed by Brewery Ommegang, in upstate Cooperstown, once the nation's prime hop-growing region. There, a husband-and-wife team of importers, Don Feinberg and Wendy Littlefield, with financial help from their Belgian suppliers, have constructed an architecturally striking farmstead brewery. It produces an abbey ale called Ommegang (named after a summer pageant in Brussels), the golden, effervescent Hennepin Ale, and the full-bodied, copper-colored Rare Vos (Flemish for "Sly Fox").

Even this country's southern tier, once considered a no-man's-land for beers with character, has been redeeming itself. The hot climate fosters a preference for lighter, fizzier styles, as embodied in Saint Arnold Fancy Lawnmower Beer from Houston. Complete with the patron saint of brewers duly posed on the label with two lawnmowers, this is a world-class German-style Kölsch with a malty body and a subtle aroma that comes from multiple additions of imported Hallertauer hops. For Texans seeking more robust styles, Saint Arnold is happy to oblige with fine entries such as a malty Brown Ale.

Frequent travelers usually need go no farther than the closest airport pub to indulge in a locally made brew. If you're a beer lover, it may even be worth mapping out your itinerary along the path of the most enticing brands. ■

IMPERIAL STOUT Rich, malty ales, ranging in color from dark copper to pitch black, greater than 8% alcohol by volume.

INDIA PALE ALE Hoppy, high-strength British

pale ales devised to withstand a ship's long journey to India. The style has been appropriated and augmented by U.S. craft brewers.

KOLSCH Light-bodied, fruity ale from the German city of Cologne with a golden color, low hop flavor, some-

times brewed with wheat.

OATMEAL STOUT Old British style that uses oatmeal to make full-flavored, smooth brews with a roasted-malt character.

ZWICKELBIER A style of unfiltered German-style beer.

Data: Michael Jackson's beer-hunter.com, Institute for Brewing Studies, BusinessWeek

More Hophead Favorites

NORTHEAST

Harpoon Brewery
Boston

Harpoon India Pale Ale

Magic Hat Brewing
South Burlington, Vt.
No. 9 (ale)

Smuttynose Brewing
Portsmouth, N. H.
Robust Porter

SOUTHEAST

Sweetwater Brewing
Atlanta

Sweet Georgia Brown (brown ale)

Abita Brewing
Abita Springs, La.
Turbodog (dark brown ale)

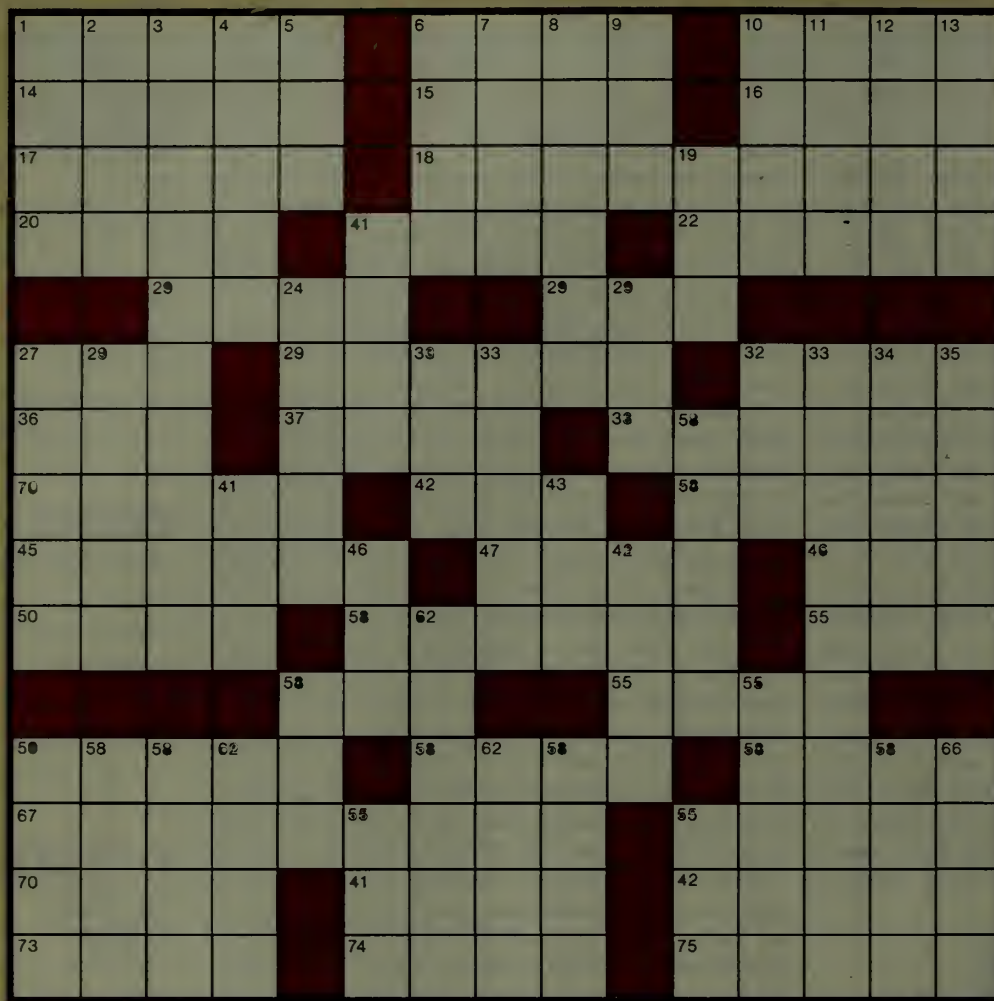
MOUNTAIN STATES

New Belgium Brewing
Fort Collins, Colo.
Fat Tire Amber Ale and Trippel Belgian Style Ale

Wynkoop Brewing
Denver
RailYard Ale



Mixing Business with Pleasure by Lincoln



DOWN

1. Fifth Avenue retailer
2. Nike competitor
3. Expert advisor
4. Stock-market stats
5. '60s college protest group
6. Hemingway's nickname
7. Medical school course
8. Software media
9. __ Maria (coffee liqueur)
10. Former German chancellor
11. Be adjacent to
12. Treasury security
13. Fortune teller
19. Aluminum product
21. Study hard
24. Make happy
26. SAT and GRE coordinator
27. Mediterranean island
28. Fields of expertise
30. Sri Lanka export
31. Additional expense
32. Top of some rating scale
33. Yahoo and Lycos
34. Like a lot
35. Bobby-__ ('40s teen)
39. Cruise ships' parking place
41. Enjoy Vail
43. Fit to be tied
46. Highway: Abbr.
48. Olympus honcho
52. Applicant's offering
54. Poetic preposition
56. Smooth transition
57. Microprocessor
58. Coop group
59. Throws in
60. "__ Rhythm"
62. Troop group
63. Mystery writer Buchanan
65. Cash register
66. Novelist Seton
68. Wonderful, for short
69. Nautical direction

ACROSS

1. Goldman's partner
6. Treaty
10. Menninger Clinic's locale: Abbr.
14. Steer clear of
15. "The King __"
16. Woodwind instrument
17. Juan Carlos and Harald
18. It may be golden
20. Ceremonial scarf
21. __ Institute (conservative think tank)
22. Amend
23. Software buyer
25. Seven Supreme Court justices
27. Prefix for content
29. Most recent
32. Christmas poem starter
36. Warhol works
37. Sodano is its CEO
38. Big name in swimwear
40. Minimal
42. S&L convenience
44. Place for some mail
45. Ship of fuels
47. Demolish
49. Opposite of post-
50. Italian wine region
51. One who works on the floor
53. "__ the ramparts..."
54. Wide shoe
55. Former UN member
57. Committee head
61. Takes to court
64. Jazz singer __ James
67. Type of investment partnership
69. Once more
70. __-European
71. Former Ugandan leader
72. "THE EMPEROR'S NEW, __ VISIBLE CLOTHES" (see page at right)
73. Attention-getting sound
74. Software test version
75. Thomas Edison rival

For answers to this puzzle:

Turn to page 93 in this week's issue of BusinessWeek or visit Mixing Business with Pleasure by Lincoln on www.businessweek.com/adsections

Puzzle created by: Stanley Newman.



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When Too Much Water Can Kill You

Distance athletes can overdo fluid replacement

BY ROBERT BERNER

Sarah Snyder thought she was taking every sensible precaution when she began training for an 85-mile charity cycling event. She gradually increased the lengths of her training rides, consuming plenty of liquids to prevent dehydration. "I thought I was being a really smart athlete by drinking a lot of water," says the 45-year-old Milton (Mass.) mother of two. It nearly killed her.

Following a 56-mile ride on May 18, Snyder developed hyponatremia, a potentially fatal condition that occurs when the body's sodium level gets too low. As in most cases, Snyder's problem resulted from drinking too much liquid—about six pints over 5½ hours. Sensing something was wrong—she was dizzy and vomited twice after arriving home—she dialed 911. The paramedic who found her collapsed in the front yard could barely feel her pulse. "I could have been a goner," Snyder says.

Preventing Liquid Overload

If you plan to compete in an endurance event lasting more than four hours, figure out your sweat rate so you'll know how much fluid you need to drink.

- 1 Weigh yourself naked before training, then again after you finish. If you exercise for an hour and lose a pound, your sweat rate is a pound an hour.
- 2 One pound equals one pint of liquid. So you would need to drink one pint, or 16 ounces, over an hour to replace the fluid lost.
- 3 Account for fluid intake, adding back the weight of what you drink to the weight you lose. If you drink half a pint and lose half a pound, you will have lost a pound without the liquid.

Hyponatremia isn't as common as dehydration, which, in severe cases, can lead to heat stroke. But health professionals say they're seeing more cases of hyponatremia at marathons, triathlons, lengthy charity walks, and other endurance events that last four hours or more. That's because more would-be athletes are participating and following age-old advice to drink a lot to avoid dehydration.

Liquids are important. But it's easy for even a sometime athlete, whose body isn't acclimated to such strenuous exertion, to overdo it. "It's crucial to understand that too much liquid can have severe consequences that may be more dangerous than taking in too little fluid," says Dr. Robert Roberts, a White Bear Lake (Minn.) physician and medical director for the Twin Cities Marathon. While it helps to down sports drinks such as Gatorade, that replenish some electrolytes, even too much of those can put you in jeopardy.

Hyponatremia occurs when the sodium level in the fluid between cells falls below the normal range of 135 to 145 milli-equivalents per liter. Sodium plays an important role in balancing the fluid between the outside and inside of cells and maintaining the right amount of water. But this balance can get dangerously out of whack when an athlete consumes liquids at a faster rate than the body can excrete them, either through sweat or urine.

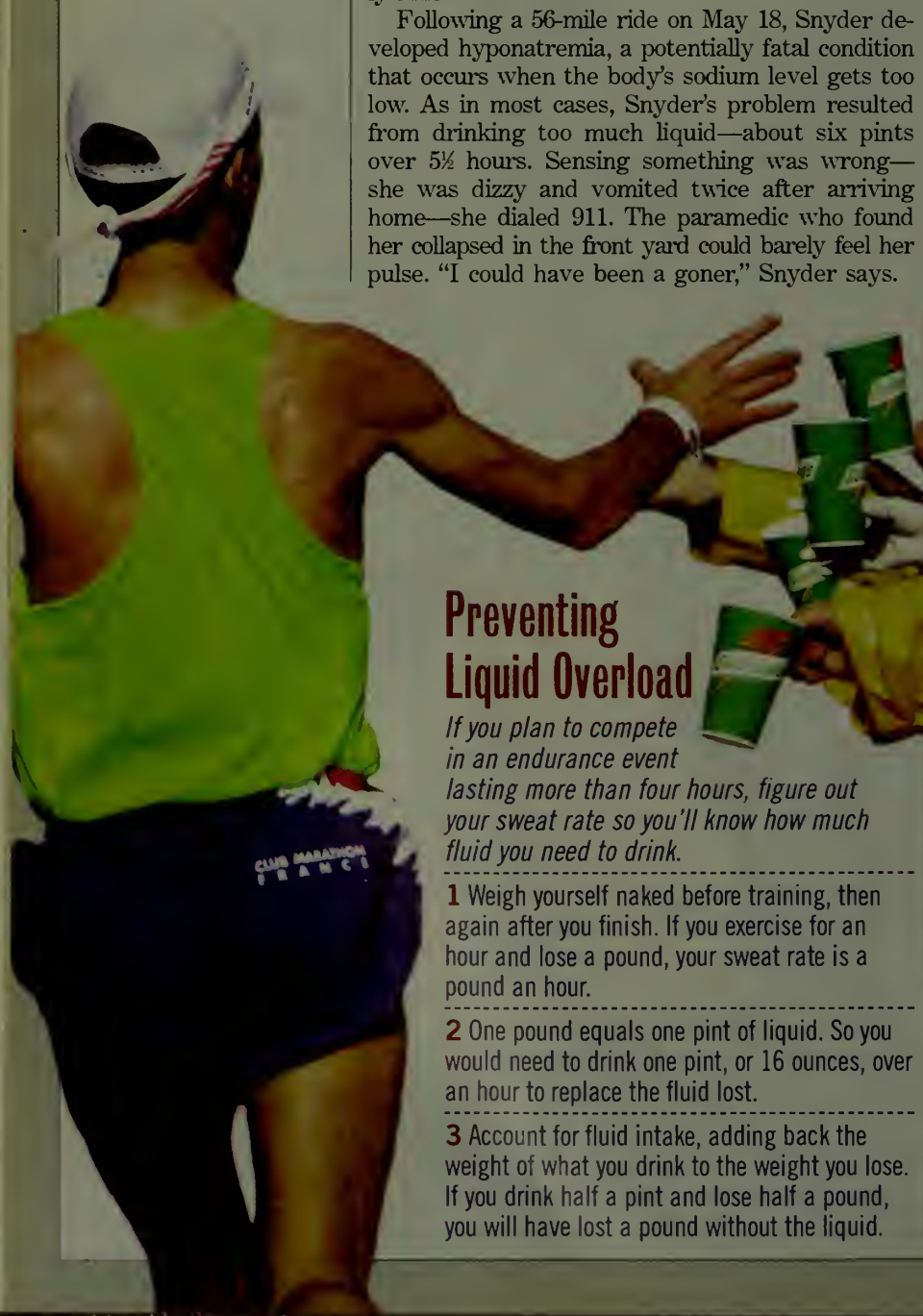
Symptoms start when cells take in more water than they can excrete, leading to a dilution of sodium in the intercellular fluid. The brain is particularly vulnerable as its cells swell against the skull. That's why the first symptoms include headaches, nausea, vomiting, and confusion. Too much pressure can cause seizures, setting off complications that can lead to death.

Experts say taking sports drinks during an event and adding extra salt to your food before the event can help prevent hyponatremia. The best precaution, however, is to know your sweat rate and replace only the fluid you lose (table). Many marathons and triathlons now warn contestants about drinking too much. A few events have even begun spacing out hydration stations farther apart as a precaution.

Once symptoms start, it can take just minutes for the condition to spiral out of control. Snyder was lucky on two counts. As disoriented as she was when she entered her home, she had the presence of mind to call 911. Then, when she arrived at the hospital, the emergency room doctor correctly diagnosed hyponatremia and treated her with intravenous salt-replacement.

Not every doctor might have made the call. Warren Scott, a Soquel (Calif.) physician with the medical team of the Hawaiian Iron Triathlon, says he has reviewed six cases in which ER docs assumed the patient was dehydrated from exertion. "The doctors worried about the situation by giving fluids to someone who was fluid-overloaded," he says. "Luckily, we realized this and were able to reverse it."

Snyder spent two days in the hospital. This time, she missed the charity ride, she plans to go next year. But next time, she'll know better than to guzzle water till she's fit to burst.



Surfing for the Best Mortgage Offer

may be surprised by the results

TRY
WONG

try to the
on wisdom
line-only
s can
cut the big
my lowest
came from
and-mortar

Despite the spate of refi-related spam cluttering my e-mail in-box for the past several months, I wasn't intending to refinance my mortgage. I had only 10 years to go on my 1997 refi, and at 7%, the interest rate was pretty good. Besides, most of the spam promises impossibly low interest rates, omitting the incredibly high up-front costs I'd have to pay to get them. Then came a pitch with a difference: I'd actually heard of the lender.

So I surfed over to Priceline.com and decided to call its bluff. True to the Priceline model, Priceline Mortgage lets you name your own rate. I filled out the 10-page application, at the end plugging in 5.875% and 0 points for a 15-year fixed loan, the same as the come-on in the e-mail and on the front page of Priceline's Web site. Five hours later, I was rejected.

I was, however, on a roll, having learned that if ever there was a time to refinance, it is now: Mortgage rates are near a 35-year low. While awaiting Priceline's response, I fiddled with the calculators that most real estate and lending Web sites furnish and discovered the more sophisticated tools at mtgprofessor.com. They allow you to play "what if" games with your mortgage, figuring in such opportunity costs as the interest you lose by taking money from other investments to pay points and closing costs.

By then, I had determined that I should hold out for a 6% rate, max. I also decided to up the mortgage a bit so I could take out \$25,000 in cash to pay for some badly needed remodeling, including a new roof for my 63-year-old house in Los Angeles. Sure, I would owe more over the long haul, but a 6% mortgage rate is effectively a 4% loan after you deduct the interest from your income tax. Even with the bigger loan, I would be saving more than \$100 a month.

I started shopping for the 6% rate in earnest. I hit the online quote engines at big mortgage banks, Countrywide Credit, Washington Mutual, and my current lender, Bank of America. I asked for quotes from a handful of online-only lenders including E*Trade, Quicken, and E-Loan. I completed the 11-page application at LendingTree, an auction site that promises to

solicit four competing bids for my business.

The instant quotes I got applied only to applicants with stellar credit, but they were good enough to narrow the field. They started at 6% and went to 6.5%, with an unexpected result: Despite the common wisdom that online lenders' efficiencies can beat the big banks with their high-cost branch networks, my two lowest quotes came from the brick-and-mortar folks. One online lender, IndyMac Bancorp, gave me its quote along with comparisons to six others—pointing out that both Washington Mutual and Bank of America had better deals that day. (I called, and IndyMac matched the best rate over the phone.)

I ended up with Bank of America. From the beginning, it had come in with the lowest package of the major national lenders by deducting slightly more than a half-point—which resulted in a credit of several hundred dollars toward closing

costs—if I filled out an application online. Did I get the cheapest deal? Probably not. I had offers from banks I've never heard of with better rates, and I suspect some of them could also have undercut my closing costs.

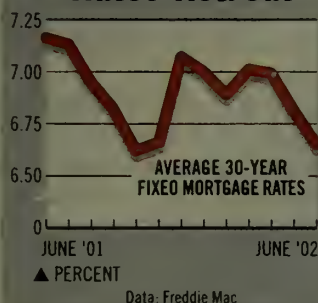
But B of A had handled my current mortgage for five years without a screw-up, and we really clicked when we got together by phone. The loan officer learned she was competing to keep my mortgage, not just to get it. I

learned what it feels like to be a valued customer. Documentation in writing? Not necessary. Appraisal? Waived. Free checking? No problem.

I signed the final loan papers 12 days later. Maybe I spent an extra quarter-percent, but hey, I got a speedy close and a comfy, satisfied feeling. I figured it was a small price to pay for top-notch service. ■



Rates Retreat



SHE'S GOTTA HAVE 'IT'



BY MICHELLE CONLIN
hers@businessweek.com

A growing mound of research shows that female execs trounce men in nearly every area of performance. But many lack "executive presence"

Work on 'It'

- Plan what you will say before you go to meetings
- Never leave a meeting without contributing to the discussion
- Lose the guarded, equivocal speaking style
- Learn to brag—be your own commercial
- Forge bonds with senior executives by opening up

She has Everest-size ambitions, a flawless track record, and an uncanny knack for strategy. "I'd love to promote her," the CEO says. "But she just doesn't have 'it.'"

"It," in this case, is executive presence, the elusive quality that has over the past year become a major focus in women's leadership development circles. This trait is so important to companies such as Shell Group and J.P. Morgan Chase that they have packed off their high-potential female managers to special seminars to develop "it," lest they wind up adding to an already depressing statistic: Women make up half of management jobs but are still just a sliver—5%—of the executive ranks.

Executive presence goes far beyond banishing the wardrobe of frumpy brown suits and stopping the nail-biting at meetings. It refers to that ability to take hold of a room by making a polished entrance, immediately shaking people's hands, and forging quick, personal connections instead of defaulting to robotic formalism and shrinking into a chair. When leaders with executive presence speak, people listen—because the talk is filled with conviction instead of equivocation. They inspire that I'll-follow-you-anywhere loyalty, conveying an aura of warmth and authenticity to everybody from the receptionist to the CEO.

It makes sense that executive presence is the latest key in unlocking women's advancement. Over the past few years, a growing mound of research has revealed that women executives trounce men in nearly every aspect of performance. But a gender gulf remains in the most crucial area: confidence. And confidence is the secret sauce in executive presence.

It sounds so utterly, self-help simple. But Cynthia Scott, a partner with San Francisco-based executive coaching firm Changeworks, says she's astounded at how often females in danger of being written off for advancement will leave a meeting without having said much—if anything. That makes them come off as passive and unengaged. When they do pipe up, Scott says, they of-

ten blow it by using qualifiers such as "I" and pronouns such as "we"—and, worst of all, the sentence with the inflection of a question, causing people to doubt what they've just said.

As long as men continue to be the primary influence on the corporate culture, the unseen-not-heard communication styles were acculturated with will continue to push them the further up the career ladder. Recent research by The Leader's Institute, a Philadelphia leadership training firm, found that top females in Corporate America were more comfortable challenging others than their male colleagues. They were also more guarded in social interaction—even though speaking

to your colleagues comes ever more important at the executive level. Building social skills is imperative for women leaders. Promote what they like and feel comfortable with.

One of the ways women can develop their "it" is by noting what they say in meetings. Coaches rehearse what to say beforehand, using their own style of decision-making without overcompensating by becoming a bully. Learn the art of a polite interruption. Fill up the room by telling a quick story. "Always communicating in the future," says Wasson, a manager at J.P. Morgan Chase who has worked at San Francisco-based Peggy Klaus. In many ways and elevator up about your past life to forge bonds with the senior team—something many women feel less riskier



burrowing into their work.

Self-promotion is also critical. In shame, female executives, coaches cringe at how high achievers dodge opportunities to tell themselves, almost as if their achievements go without saying. "Women need to learn to brag," says Klaus, who holds boasting seminars at companies such as Pfizer. One strategy: turn accomplishments into anecdotes. Lighten the self-deprecation and pour on more hubris.

The best news about confidence is that it's easier to develop than competence—the part of the job senior women usually have licked. Now they just need to start working on their "it."

Hers columnist Toddi Gutner is on special assignment.



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LEND HALF AN EAR TO THIS DOOMSAYER



BY ROBERT BARKER

rb@businessweek.com

Think the market is rotten now? It's about to get worse, much worse, according to Bob Prechter. Worried about Dow 8000? Prechter would tell you he can see Dow 800. (No typo there—that's Dow Eight Hundred.) Worse, perhaps, is that in Prechter's scenario, few of the familiar havens offer shelter. Downgrades will savage corporate bonds. Municipalities will default on their debt. Even Uncle Sam's credit status will be tested. Meantime, real estate will go bust. Forget contrarianism. "In this market," Prechter told me, "it's the bear who is your friend."

If few people today know the name Robert R. Prechter Jr., few investors 15 years ago didn't. A onetime Merrill Lynch technical analyst, Prechter and his newsletter, *The Elliott Wave Theorist*, began gaining renown in the early '80s. He correctly saw that a long trend of rising inflation was giving way to an era of disinflation. Prechter called the bear market's August, 1982, nadir and, working from his home in Gainesville, Ga., became an off-Wall Street guru. By 1987, *The New York Times* called him "both prophet and deity, an adviser whose advice reaches so many investors that he tends to pull the market."

That moment, however, would prove to be Prechter's zenith. Steadily bearish calls led his followers far astray from the 1990s' humongous stock market gains—his worst error, Prechter, who is now 53, readily conceded. Given this mixed record, it's a surprise to find Prechter's latest book, *Conquer the Crash* (John Wiley & Sons, \$27.95) at No. 1 among Amazon.com's best-selling business and investing titles. "What I want to do is be an antidote," he told me. To most investment advisers, "it's only a question of, 'Is it this group of stocks or that group? This sector or that sector? U.S. stocks or European stocks?' That's not where people should focus. They should be in something that's very unpopular right now: cash" (table).

Prechter comes to this conclusion less from economics than psychology, his major at Yale University. Later, while at Merrill, he picked up the "wave" theories developed during the Depression by an accountant named R.N. Elliott.

These hold that market prices follow patterns driven by a natural rise and fall in human emotions. In this deterministic scheme, higher than emotions—and markets—further they must eventually fall under the weight of an economywide accumulation of much debt and the ensuing defaults.

So in his Elliott Wave charts, Prechter predicts an inevitable stock market collapse that has begun, an economic depression, and a taking deflation in the prices of most everything of asset. Houses worth \$500,000 today are up going for \$150,000—or less. Bankruptcies will fail, so Prechter's book points to those with the safest balance sheets. In such a climate, he thinks George W. Bush is another single-term Bush. "Most radical po-

velopments occur or near social bottoms, which were major stock bottoms."

Prechter does not expect his forecast to move money markets back. In that he's no doubt One successful seller with a technical analysis, me he never Prechter's work knows no one does. Timothy a bearish sentiment, ing firm specializing in technical analysis Davis Research

PRECHTER: Insights into investor psychology

Prechter's view "sounds a little dire. More predictably, long-term bulls scoff. professor Jeremy Siegel, author of *Stocks for the Long Run* (McGraw-Hill, \$29.95), to give depression, deflation, and a bank-lapse zero probability. "That cannot be under any circumstance," he added. "I have any amount of money on that."

I've got my chips with Siegel's. So why am I not paying Prechter any mind at all? Because the critical role of market psychology, he is right than Wall Street's Establishment admits. Why are stocks in companies that are cookies for your stomach more valuable than those making cookies for your hair when three years ago the reverse was true? Yes, it's prospects for profit growth. But in large measure a matter of investor sentiment. I don't see bread lines around the corner. In a bear market, it helps to take a look at the eyes of the most fearsome grizzly.

A Big Bear's Advice

SELL

- ▶ Stocks
- ▶ Corporate bonds
- ▶ Municipal bonds
- ▶ Real estate
- ▶ Most commodities
- ▶ Collectibles

BUY

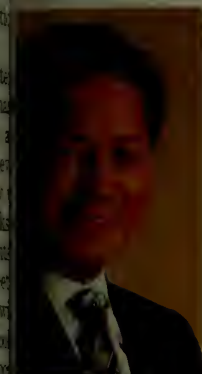
- ▶ "Safe" bank CDs*
- ▶ Silver, gold, platinum
- ▶ U.S. Treasury bills
- ▶ Swiss government money-market securities
- ▶ Rydex Ursa Fund (RYURX)
- ▶ Prudent Bear Fund (BEARX)

*Issued by banks carrying highest safety ratings by Weiss Ratings Inc.

BusinessWeek online

For a Q&A with Prechter, go to barker.online.businessweek.com/investor/ and click on "Q&A with Prechter."

BOONE RIDES AGAIN



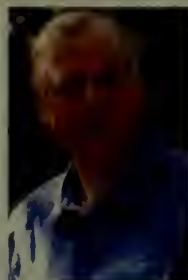
Gene G. Marcial

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It looks as if T. Boone Pickens Jr., the erstwhile hostile takeover king, is back in the game. For 15 years, Pickens all but disappeared. In the 1980s, he shook up Corporate America as he tried to raid Gulf Oil, Diamond Shamrock, and Phillips Petroleum, setting off fierce takeover battles. Now 74, Pickens is limiting his picks to smaller outfits: On June 25, BP Capital Energy partnerships, which Pickens controls, made a bid to buy Penn Virginia, an oil-and-gas explorer, for \$329.6 million, or 40 a share. BP already owns 7.6% of Penn, whose stock spurted 15%, to 38.68, on the news. Penn rejected the offer, but the battle is on.

Now the buzz is that Pickens will go after Vintage Petroleum (VPI), of which BP Energy already owns more than 9%. It paid 14.66 on average for its shares, which now trade at 10. And BP Energy Managing Director Bob Stillwell confirmed that BP is, indeed, considering a bid for Vintage, which he says is undervalued and ripe for a buyout. He declined to discuss the timing or price. Vintage didn't return calls.

Initial interest in Vintage was revealed on May 15 in a 13D filing by BP Energy, in which BP proposed a restructuring of Vintage to pay off its \$1 billion debt. Pickens would sell Vintage's entire U.S. assets and part of its Canadian reserves to come up with \$800 million. Instead of heeding Pickens, Vintage declared war by dropping—from 15% to 10%—the amount of stock an outsider might own without activating an antitakeover "poison pill." And in mid-June, Vintage said it had sold reserves in Trinidad but was keeping U.S. assets. Vintage earned \$2.09 a share in 2001, on sales of \$909 million.



PICKENS: Back on the prowl

OCULAR: THE APPLE OF A RIVAL'S EYE?

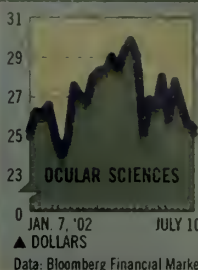
In contact lenses, Ocular Sciences (OCLR) is tops, says analyst Suey Wong of investment firm Robert W. Baird. Not only are its sales growing fastest—at three times the industry's average global pace—but Ocular is also "a very attractive takeover target," says Wong, who rates the stock a strong buy. He doesn't own shares, nor does his company do banking for Ocular. Spurred by its new products and experienced sales force, Ocular is No. 4 in lens sales: Only Johnson & Johnson, Ciba Vision, and Bausch & Lomb are larger. But in the \$2 billion-a-year market for standard disposable lenses, Ocular is second only to J&J. Ocular also makes soft disposables.

Based on recent industry deals, Ocular, now trading at 25, is worth three times its sales of \$254

million, or 35 a share, figures Wong. He thinks Bausch & Lomb is the most likely suitor. He recalls that Bausch lost out to Ciba in its bid in 2000 for Wesley Jessen, another lens maker. So Wong expects Bausch to go after Ocular, to better compete with J&J and Ciba.

On fundamentals, Ocular is already worth 33, says Wong, based on 16.5 times his 2003 estimate of \$2 a share. He expects earnings of \$1.72 this year. Analyst Marc Goodman of Morgan Stanley, which led Ocular's underwriting of share offerings in 1998 and 1997, sees Europe as the next growth area for Ocular, where it has a 10% share of the \$600 million contact-lens market, vs. 20% in the U.S. A Bausch and Lomb spokeswoman wouldn't comment on its acquisition plans. Ocular CEO Stephen Fanning says "our goal is to continue the company's rapid growth."

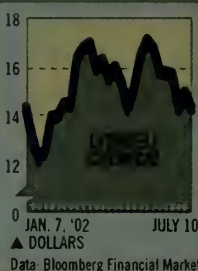
LOW PRICES DRAW SECOND LOOKS



GOOD CHEMISTRY AT LYONDELL

Lyondell Chemical (LYO) "isn't the kind of stock we normally have in our portfolio," says value investor Scott Black, president of Boston's Delphi Capital Management. It is highly leveraged, with a debt burden of \$3.9 billion, he notes, because of an acquisition in 1998. "But we've bought shares because it's an attractive play on the recovery," he says, "and an overdue snapback in chemicals." The time to buy chemical stocks is when nobody wants them—and before prices shoot up, he argues. A leading low-cost producer of propylene oxide, ethylene, and polyethylene, Lyondell has been improving its balance sheet and making sure that the dividend payout of 6% is protected, says Black. He figures Lyondell will post a loss this year but earn \$1 a share in 2003. The big payoff, however, will be in 2004, when Black expects earnings of \$4 a share. Nancy Traub of Credit Suisse First Boston thinks the chemical supply-and-demand cycle bottomed out in 2001. A combination of restocking, demand growth, and limited plant-capacity expansions, she says, will lead to higher prices, margins, and earnings through 2004 and 2005. She doesn't own shares. Credit Suisse First Boston is advising Lyondell on buying some assets from Occidental Petroleum.

HARDLY BUBBLING UP

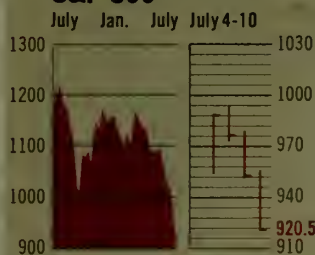


BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:45 p.m. EST on CNNfn's *The Money Gang*.

Stocks

S&P 500



COMMENTARY

President Bush's speech to Wall Street on July 9 did little to reassure the market. Stocks continued to slide. For the week, the S&P 500 sank 3.5% to its lowest level since August 1997. The Dow Jones industrial average lost 2.7% and the Nasdaq 2.5%. Along with fear of more corporate scandals and fear itself, investors are scared of the start of the new earnings reporting season.

Data: Bloomberg Financial Markets
Reuters

U.S. MARKETS

	July 10	Week	Year to date	Last 12 months
S&P 500	920.5	-3.5	-19.8	-22.1
Dow Jones Industrials	8813.5	-2.7	-12.1	-13.4
Nasdaq Composite	1346.0	-2.5	-31.0	-31.4
S&P MidCap 400	447.3	-3.2	-12.0	-10.1
S&P SmallCap 600	212.2	-2.0	-8.6	-3.7
Wilshire 5000	8716.4	-3.1	-18.6	-20.5

SECTORS

BusinessWeek 50*	561.2	-5.9	-23.1	-31.3
BusinessWeek Info Tech 100**	288.8	-2.0	-31.1	-32.9
S&P/BARRA Growth	457.3	-3.8	-23.1	-21.8
S&P/BARRA Value	460.3	-3.2	-16.6	-23.0
S&P Energy	203.7	-4.1	-3.6	-9.5
S&P Financials	314.2	-2.8	-11.6	-14.8
S&P REIT	96.9	-2.3	3.8	4.8
S&P Transportation	189.2	-2.2	-3.9	-5.5
S&P Utilities	107.3	-8.3	-26.4	-44.5
GSTI Internet	66.3	-2.7	-36.9	-46.0
PSE Technology	458.3	-4.7	-33.3	-29.8

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Footwear	9.7	67.0
Metal & Glass Containers	0.5	35.7
Airport Services	NA	33.7
Alternate Carriers	NA	33.0
Retail Catalogs	NA	32.0

EQUITY FUND CATEGORIES

4-week total return	%	52-week total return	%
Leaders		Leaders	
Japan	0.7	Precious Metals	76.9
Diversified Pacific/Asia	0.0	Pacific/Asia ex-Japan	15.0
Pacific/Asia ex-Japan	-0.1	Real Estate	12.5
Precious Metals	-1.4	Diversified Emerging Mkts.	9.4
Laggards		Laggards	
Technology	-11.3	Communications	-45.5
Communications	-10.7	Technology	-40.5
Health	-10.1	Utilities	-29.7
Mid-cap Growth	-9.6	Health	-29.5

EQUITY FUNDS

4-week total return	%	52-week total return	%
Leaders		Leaders	
Rydex Dynamic Vent. 100	17.4	First Eagle SoGen Gold	113.8
ProFunds UltraShort OTC	17.1	Van Eck Intl. Invs. Gold A	103.6
ProFunds UltraBear Inv.	11.3	Monterey OCM Gold	95.3
Leuthold Grizzly Short	11.2	U.S. Global Investors Gold	95.3
Laggards		Laggards	
ProFunds UltraOTC Inv.	-21.1	ProFunds UltraOTC Inv.	-70.9
Van Wagoner Post Venture	-21.1	Black Oak Emerging Tech.	-66.9
Van Wagoner Technology	-20.1	Van Wagoner Post Venture	-66.0
Monterey Mur. N. Wild. Tech.	-19.9	Van Wagoner Technology	-63.8

Data: Standard & Poor's

GLOBAL MARKETS

	July 10	Week
S&P Euro Plus (U.S. Dollar)	979.8	2.1
London (FT-SE 100)	4420.1	0.1
Paris (CAC 40)	3656.4	0.1
Frankfurt (DAX)	4190.2	1.1
Tokyo (NIKKEI 225)	10,752.7	-0.1
Hong Kong (Hang Seng)	10,787.5	2.1
Toronto (TSE 300)	6916.4	-1.1
Mexico City (IPC)	6371.3	0.1

FUNDAMENTALS

	July 9
S&P 500 Dividend Yield	1.67%
S&P 500 P/E Ratio (Trailing 12 mos.)	40.5
S&P 500 P/E Ratio (Next 12 mos.)*	16.7
First Call Earnings Surprise*	5.02%

*First Call Corp.

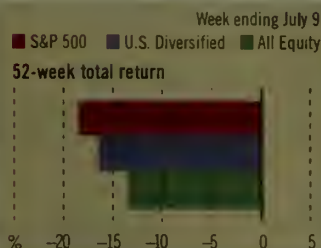
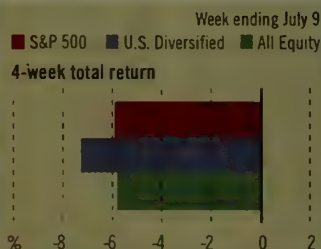
TECHNICAL INDICATORS

	July 9
S&P 500 200-day average	1098.2
Stocks above 200-day average	48.0%
Options: Put/call ratio	0.88
Insiders: Vickers NYSE Sell/buy ratio	3.98

WORST-PERFORMING GROUPS

	Last month %	Last 12 months %
Advertising	-32.1	Multi-Utilities
IT Consulting	-30.3	Wireless Serv
Broadcasting & Cable TV	-26.9	Movies & Ent
Office Electronics	-26.1	Telecomms. E
Wireless Services	-24.7	Application S

Mutual Funds



Data: Standard & Poor's

Interest Rates

KEY RATES

	July 10	Week
MONEY MARKET FUNDS	1.46%	1.1%
90-DAY TREASURY BILLS	1.71	1.7
2-YEAR TREASURY NOTES	2.58	2.7
10-YEAR TREASURY NOTES	4.61	4.7
30-YEAR TREASURY BONDS	5.34	5.4
30-YEAR FIXED MORTGAGE†	6.46	6.5

†BancQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENT

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 30% federal tax rate.

	10-yr. bond
GENERAL OBLIGATIONS	4.07%
TAXABLE EQUIVALENT	5.81
INSURED REVENUE BONDS	4.24
TAXABLE EQUIVALENT	6.06

THE WEEK AHEAD

BUSINESS INVENTORIES Monday, July 15, 8:30 a.m. EDT ► Inventories are forecast to have declined 0.2% in May. That's based on the median forecast of economists surveyed by Standard & Poor's MMS, a unit of The McGraw-Hill Companies. In April, inventories fell 0.2%.

INDUSTRIAL PRODUCTION Tuesday, July 16, 9:15 a.m. EDT ► Factory output in June most likely increased 0.5%, after rising 0.2% in May. The average operating rate probably increased to 75.8%.

NEW RESIDENTIAL CONSTRUCTION Wednesday, July 17, 8:30 a.m. EDT ► Housing starts most likely fell back to an annual rate of 1.68 million units in June.

LEADING INDICATORS Thursday, July 18, 10 a.m. EDT ► The Conference Board's June composite index of leading economic indicators probably rose by 0.1%.

CONSUMER PRICE INDEX Friday, July 19, 8:30 a.m. EDT ► Consumer prices for goods and services are expected to have

risen 0.2% in June. Excluding food and energy components, core June probably rose by 0.2%.

INTERNATIONAL TRADE Friday, July 19, a.m. EDT ► The trade deficit narrowed slightly to \$35.3 billion from \$35.9 billion in April.

FEDERAL BUDGET Friday, July 19 ► The U.S. Treasury probably posted a \$31.9 billion surplus in June, compared to a \$31.9 billion surplus in June,

Mixing Business with Pleasure by Lincoln

BusinessWeek Fifty

Jan.

July

Weekly

Daily: July 4-10

640

620

600

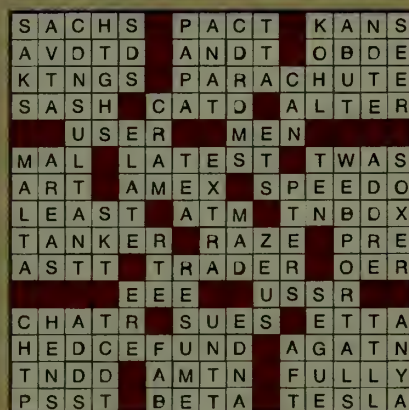
580

561.2

ed 5.9% for week ended July 10. Leading the decline were energy providers Calpine, Dyne-
gy, which fell 17.8%, 16.0%, and 12.6%, respectively, on profit worries. Merck plunged 7.8%
ng controversy and again postponed an IPO for Medco, which handles employee drug-ben-
ata Systems, climbing 5.1%, led the only five stocks of the BW 50 to rise for the week.

COMPANY PERFORMANCE

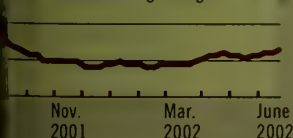
	% change		Rank	Company	% change	
	Week	Since 3/1/02			Week	Since 3/1/02
hanson	-5.0	-17.4	26	Tenet Healthcare	-3.9	18.9
	-4.1	-10.8	27	Household International	-8.3	-14.4
	-4.5	-24.2	28	WellPoint Health Networks	-2.2	24.7
	-4.1	-11.1	29	Washington Mutual	-6.1	6.5
	-0.2	-14.2	30	Duke Energy	-12.6	-26.3
Bergen	-4.6	-30.0	31	Kohl's	-0.3	3.5
	-3.0	-10.9	32	Bed Bath & Beyond	-10.1	-2.2
	-2.2	-4.8	33	Cardinal Health	-8.1	-20.5
	0.8	-21.9	34	Centex	-4.4	-9.9
	-9.6	-7.0	35	American Electric Power	-7.7	-19.6
Group	-2.2	21.7	36	Golden West Financial	-4.2	0.8
	-8.0	-5.9	37	Stryker	-7.0	-23.6
	-9.8	-33.5	38	Harley-Davidson	1.1	-3.9
	-2.3	-13.3	39	PepsiCo	-6.0	-11.7
	-16.0	-77.9	40	Merck	-7.8	-29.0
mics	-0.6	13.6	41	Apache	-4.2	3.1
	-2.6	-5.4	42	Amerada Hess	-3.4	11.4
	-5.2	-17.0	43	KB Home	-1.0	13.8
	-0.5	-8.8	44	First Data	-10.2	-20.1
	-17.8	-27.2	45	Tyco International	2.7	-55.3
petroleum	-3.4	3.9	46	International Game Technology	0.8	-16.1
	-3.8	-16.1	47	Capital One Financial	-10.6	4.3
	-2.3	0.0	48	Electronic Data Systems	5.1	-42.4
	-1.7	-6.9	49	Nabors Industries	-4.5	-1.7
	-1.2	-19.2	50	Xcel Energy	-7.6	-40.8



Production Index

Change from last week: 0.3%
Change from last year: -3.3%

OUTPUT June 29=162.8 1992=100
Index is a 4-week moving average



ex turned in a solid performance. Be-
the four-week moving average, the in-
162.3 to 164. On a seasonally ad-
ric power, along with auto and truck
the index higher. Coal and rail-freight
positive for the week. Steel and lum-
d, and crude-oil refining remained
d. The production index during June
n 161 for all of May.

the index components is at www.businessweek.com
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IT'S TIME FOR A NEW ERA OF REFORM

For some time now, *BusinessWeek* has been calling for serious reform of Corporate America. Even as some business and political leaders were in denial about the deep, systemic problems that were eroding confidence in the stock market, this magazine urged major changes in accounting, corporate governance, and Wall Street practices. So it is gratifying to see a once-reluctant President George W. Bush throw the full weight of his office behind reform. That the Business Roundtable and the U.S. Chamber of Commerce are belatedly expressing outrage at corrupt CEOs and their fraudulent business practices is also welcome. With luck, investors could once again have financial numbers they can trust and a stock market based on true value rather than fakery, and honesty instead of smoke and mirrors. The cleanup of Corporate America has begun in earnest (page 26).

And none too soon. The drop in equity prices has sharply tightened financial credit in recent weeks, neutralizing to a large degree the massive monetary easing of the Federal Reserve. The stock market has risen 20% in all but two business-cycle recoveries during the past century. This time, however, it is actually down by nearly that much. A growing number of companies, most of them small and midsize ones, simply cannot borrow or raise money by selling stock. The situation threatens to spiral downward. Investors, unable to believe financial statements and unwilling to take risks, pulled as much money out of equity mutual funds in June as they did in the weeks after September 11. Unless checked, the recovery could be aborted—hardly what the nation needs at a time of terrorist threats, rising unemployment, and slumping markets (page 68).

A SYSTEM CORRUPTED

The momentum for reform has been slowly building all spring and summer, but it reached its peak with the President's speech to a Wall Street audience on July 9. Bush began by putting on his best "hang 'em high" face, promising to "root out corruption" and establish "a new ethic of personal responsibility in the business community." At first, the President focused on punishing Corporate America's "bad apples." He used his executive powers to create a new federal financial-crimes "SWAT team" to hunt down culprits. He proposed doubling prison terms for CEOs guilty of financial fraud, freezing improper payments to corporate execs, forcing managers who benefit from false accounting to forfeit their gains, and getting the Securities & Exchange Commission to ban convicted chief executives from ever serving on a board.

But then Bush went further. For the first time since Enron Corp. blew up, he admitted that the system itself had been corrupted and needed repair. He threw his support behind a long list of changes being proposed from deep within the business community. This is critical because if reform is to work, it must come from within Corporate America and

Wall Street. Bush endorsed the New York Stock Exchange proposals to increase the number of independent members at least half the boards of directors and to insist members of key audit, compensation, and nominating committees be independent. He praised SEC proposals to keep accounting firms from providing many types of consulting services to audit clients. And he supported Wall Street efforts to make analysts "trusted advisers, not salesmen," ending conflicts of interest. The President even endorsed institutional investors' calls for boards to stop making big loans to corporate officers and urged shareholders to vote on all stock option plans. Perhaps most important, he backed the SEC demand that by Aug. 14, the CEOs of the top 1,000 public companies must personally certify their financial statements—and all future ones. This should provide a new, honest, and believable bottom-line benchmark for investors.

LET'S GET CRACKING

Yet the President should have gone further. He should have come out in support of the tough Senate accounting bill proposed by Senator Paul S. Sarbanes (D-Md.). That bill would establish a strong independent oversight board for the accounting industry, which desperately needs one. By preferring the weaker House bill, the President has missed an opportunity to sign whatever reform legislation lands on his desk. It's now up to Congress to deliver.

President Bush—and Vice-President Dick Cheney—also do well to address lingering doubts about their impartiality in business dealings. Confusion over revenue recognition, insider trading, and a pattern of late filings of stock sales to the SEC is undermining the President's credibility as a corporate reformer. Cleaning house and dumping Administration members tainted by Enron or other conflicts of interest would also send a powerful signal to the American public.

The markets are taking a "show me" stance toward reform, as they should. Weary of corporate malfeasance and bad judgment—the trusted drugmaker Merck & Co. refused to admit inflating its revenues—some investors are waiting until Aug. 14, when CEOs sign off on their sworn clean books, before buying stocks again. They want to see how reforms are implemented.

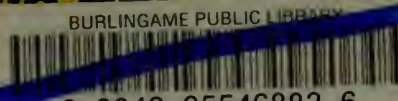
The sooner reforms are put in place, the quicker the market will return to the stock market, and the faster America can return to its brand of entrepreneurial capitalism. The speed of reform itself may restore the country's leadership on the global scene by showing how quickly it can heal its economic ills, in contrast to Japan and other nations. The U.S. has reformed its economy many times in the past. We had an Age of Reform under Theodore Roosevelt. We had an Era of Reform under Franklin Delano Roosevelt. Now we trust we are entering a new corporate cleanup. Let the reforms begin.

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July 29



MARKET: WHAT I



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CAN YOU AFFORD TO RETIRE?

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New Strategies for Tough Times

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Bezos Believes

"There's so much more to come," says Amazon's founder and CEO Jeff Bezos, in a wide-ranging interview on the company's future. But don't expect any bricks-and-mortar stores



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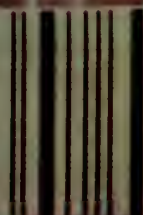
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Up Front

EDITED BY SHERIDAN PRASSO



STREET TALK

HOT SEATS ON THE NYSE

DESPITE AN 18% DECLINE in the New York Stock Exchange Composite Index so far this year, the price of a seat there has risen by almost 14%. Seats entitle their holders to buy and sell shares on the exchange floor, and brokers say the price is an important measure of market sentiment. After falling to \$1.65 million in 2000, the price of a NYSE seat hit \$2.5 million on July 10, just shy of the all-time high of \$2.65 million, reached in 1999.

Why the increase? The NYSE won't comment, but insiders point to rising daily volume, up 14% this year, and to consolidation among brokers that results in fewer seats for sale. Also, the switch to

PRICEY: decimalization has increased \$2.5 million institutional reliance on

floor brokers for various technical reasons. Plus, "there's a flavor to being on the floor, to getting the body language and nuances," says Ananth Madhavan, co-author of a study on seat prices and managing director of research at ITG, which operates POSIT, an electronic stock-order matching system.

The market for seats is a thin one. Only a half-dozen or so change hands each year. Yet the rising prices are a vote of confidence in the markets, says veteran broker Richard Rosenblatt who runs his own firm. "It's clearly a bet on tomorrow." Now, if only stock prices would follow suit. *Robert J. Rosenberg*

THE LIST THE CORPORATE NAME GAME

Over the past few months, several companies have adopted new names. What were they thinking?

NEW NAME	OLD NAME	REASON
MONDAY:	PWC CONSULTING	The consulting arm of PricewaterhouseCoopers wanted a distinct identity after breaking off from its parent, signifying a "fresh start, a positive attitude."
	CONSIGNIA	After spending millions to switch to Consignia in 2001, Britain's postal service found the public hated it. It will switch to Royal Mail later this year.
	E-DISTRICT.NET	The British interactive-TV company wanted to "demonstrate the two-way nature" of its products. The new name plays on "you" and "me."
	TRICON GLOBAL RESTAURANTS	"Tri" no longer made sense after the parent of Pizza Hut, Taco Bell, and KFC acquired Long John Silver's and A&W restaurants.

Data: BusinessWeek, company reports

TALK SHOW "It is not that humans have become greedy than in generations past. It is that the avenue express greed had grown so enormously."

—Federal Reserve Chairman Alan Greenspan

SHOPAHOLICS

SISTER, CAN YOU SPARE ME A BUCK?

KARYN, A TWENTYSOMETHING Brooklynite and admitted shopaholic who does not want her last name printed, has racked up \$20,000 in credit-card bills in the past two years. And she readily admits that her purchases were hardly emergencies. "It was completely all shoes and purses and CDs and lattes," she says. But when Karyn lost her \$100,000-a-year TV-production job in December, it took four months to find a new job at half the salary. Now she swears she has re-

formed—and hung Prada shoes forever wearing Old Navy her hair herself, and her goodies on eBay.

And, to help pay debt, she's soliciting of \$1, at www.savek. In her first week word spread, and she



ed \$400 the re have be Karyn her e-m ical. " hurt an spendi much she pre was a helping economy." She has Consumer spending grew 3.1% in 2001 prevent the econo cratering. *Heather*

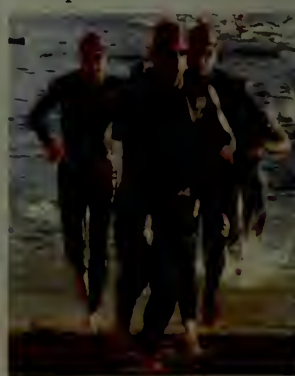
HONCHOS

CALL 'EM WHAT YOU WILL, THEY AIN'T V

FOR CEOS THESE DAYS, IT CAN'T hurt to be able to outrun shareholders. Is that why 19 top managers from Motorola, Citadel Group, Templeton

Holowesko, 42, a cor yachtsman and cycl eligible are COOs, pr owners, and presiden women are among th

Global Advisors, Unisys, and others are taking the Ironman CEO Challenge on July 28?



IRONMEN: CEO triathlon

Participants in the famously grueling triathlon will swim 2.4 miles, bike 112 miles, then run 26.2 miles in the hope of being crowned "Fittest CEO." They'll make up a subgroup of the 1,700 athletes at the Ironman USA Triathlon in Lake Placid, N.Y., a qualifying stop on the way to the world championship in Kona, Hawaii, next fall. "I have no idea whether this will be fun," says Templeton's Bahamas-based CEO Mark

Exec higher fees—\$4 \$375 for ers—and choice an private a recept past 1 champs, at the lu Mirror Inn, and bike po "They

have to line up w masses," says Ted F of Ironman Motivatio challenge organizer. T are psyched, and th talk is flying. Holowes fellow participants ha e-mailing him, saying: waiting for you at th line." *Gerry Khe*

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APPETITE SPOILERS

TAKING A BITE OUT OF TRADITION

THE SCENE IS PART STEVEN Spielberg, part Sam Peckinpah. It features Chinese newlyweds strolling dreamily into a wedding banquet, unaware of the carnage around them: The hem of the bride's gown is soaked with blood, and mutilated sharks lie everywhere.

The gory image is one of a series of wedding scenes appearing on hundreds of thousands of free postcards printed and distributed in Asia by the Singapore chapter of the Sea Shepherd Conservation Society, based in Malibu, Calif. The group is



POSTCARD: Shock attack

working to halt the rapid decline in numbers of sharks worldwide by discouraging Asians from eating shark fin soup. Real sharks were used to produce the photographs. "We have to hit people as hard as we can," says Grant Pereira, a Singaporean of Portuguese descent who heads the chapter there. "If they eat it as a status symbol, we have to attack that."

Shark fin soup is a Chinese delicacy and is *de rigueur* at Chinese banquets. Top-quality soup with an entire fin intact can cost \$100 per person. Sea Shepherd estimates that up to 40 sharks are killed to produce soup for a 500-guest wedding. The group's biggest concern is "finning," where fisherman merely hack off the fin and throw the rest of the shark overboard to bleed to death.

Singapore Airlines dropped the soup from its first-class service last year because of pressure from the group, Pereira says, and popular Singaporean TV actress Zoe Tay removed it from the menu at her wedding for the same reason.

Widening the campaign, the group has placed the images in magazines such as *Asian Geography* and *Hemisphere*. In Hong Kong, backers have distributed 60,000 postcards, and Pereira is looking for help to circulate the cards elsewhere in Asia—and in the Chinatowns of New York and San Francisco. Sharks need all the friends they can get. *Frederik Balfour*

DRAWN & QUARTERED



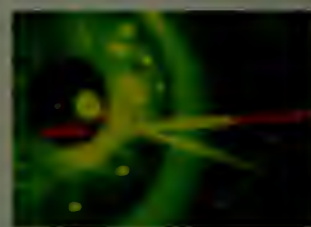
COMBAT READY

JOIN THE ARMY, SEE THE WORLD... BETTER

IF PRESIDENT BUSH ENDS UP sending U.S. troops to Iraq, he'll be able to count increasingly on an eagle-eye fighting force: The Army is ramping up use of laser surgery to give GIs better vision. Army doctors, who started the operations three years ago at Fort Bragg, N.C., have expanded to five new centers in the U.S. and Germany. Combat troops have priority, and thousands have signed up for the voluntary procedure.

Laser correction gives troops tremendous advantages in battle, medical experts say. Contact lens wear-

ers can find themselves ed by dust and sand in bat zones such as the sian Gulf. Eyeglass w can find it hard to ju landing craft onto a and must deal with f and perspiration. "The



LASER OP for more GIs

ty to g combat w glasses co lifesaving Colonel V Parmley, of corne vices at gan Army ical Cent Tacoma, Wash. Docto troops about the risk for many soldiers, w glasses or contacts in can be far riskier than surgery. *Stan*

SCANDAL SHEET

KINDA HIGH FOR A REPO

FOR SALE: PRIVATE JET. WIRED office, leather interior, two divans, satellite communications. Repossessed from Enron. Asking price: \$37 million.

Delivered to Enron in April, 2001, the Gulfstream V is nearly new, with only 380 hours of flying time. The price made "good sense" when a German bank (Bayerische Hypo-und Vereinsbank) listed it in February, says Rick Engles of Vance & Engles Aircraft Brokers in Washington, D.C. Brand-new models generally sell for \$40 million. Since then, brokers say, the average price of a used one has dropped to \$33 million.

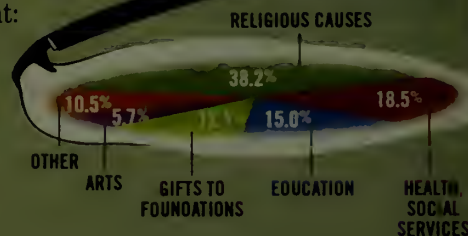
That makes the jet's asking price a little inflated—just like Enron's stock not so long ago. *Andrew Heller*



THE BIG PICTURE

HELPING HANDS

Individuals, foundations, and corporations donated about \$212 billion to charity last year. Here's where the money went:



Data: American Association of Fundraising Counsel Trust for Philanthropy

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A TECH ACE MOVES UP

When you've got a tech bust coinciding with a telecom bubble and an Internet bubble, it helps to keep everything in perspective. Kathy Rebello, who has just been appointed *BusinessWeek* assistant managing editor for technology, remains calm. Her view: It's the nature of the beast.

Rebello's equipoise dates back to her days at *USA Today*, where she opened the paper's Silicon Valley bureau in 1985. "When I arrived, Silicon Valley was in a frothy period, everything in excess. I wasn't there more than a few months before a downturn began that was the industry's biggest ever until this one. I saw what happened. Tech is a boom and bust industry. Busts are the time when people put their brains in high gear to come up with surprising, unexpected stuff."

A native of California, Rebello graduated from San Jose State University, where she was editor of the college daily. She was a reporter for the *San Bernardino Sun* before joining the fledgling *USA Today* in Washington. She joined *BusinessWeek* in 1991 as a reporter in San Francisco. When she became bureau chief in 1995, she moved our bureau to San Mateo, in Silicon Valley, and then built it up to eight people.

Over the course of 10 cover stories and hundreds of other pieces, Rebello

reported the tech beat inside a Her 1996 cover, "Inside Microsoft on how Bill Gates came late to Internet and how he turned the pany around, is one of the best tive stories we've done.

Rebello became first bicoastal senior tor in 1997, shuttling between New York and Silicon Valley. Her first team project was a double issue, "Silicon Valley: How it really works" (Aug. 25, 1997). She has been the backbone of our splendid Tech coverage, including *BusinessWeek e.biz*, our annual Info Tech ranking (June 24 is No, there aren't two

her (though sometimes we think She'll still work both coasts.

We also mark the retirement of Assistant Managing Editor G. I. Wallace. In 22 years at *BusinessWeek*, Dave did every job with energy, dedication, and distinction—from covering the Federal Reserve to running our news section as a senior editor, overseeing tech coverage as assistant managing editor. Dave was a strong voice of reason on just about everything. I'm proud to have been his colleague.

Stephen B. Shepard
 Editor-in-Chief



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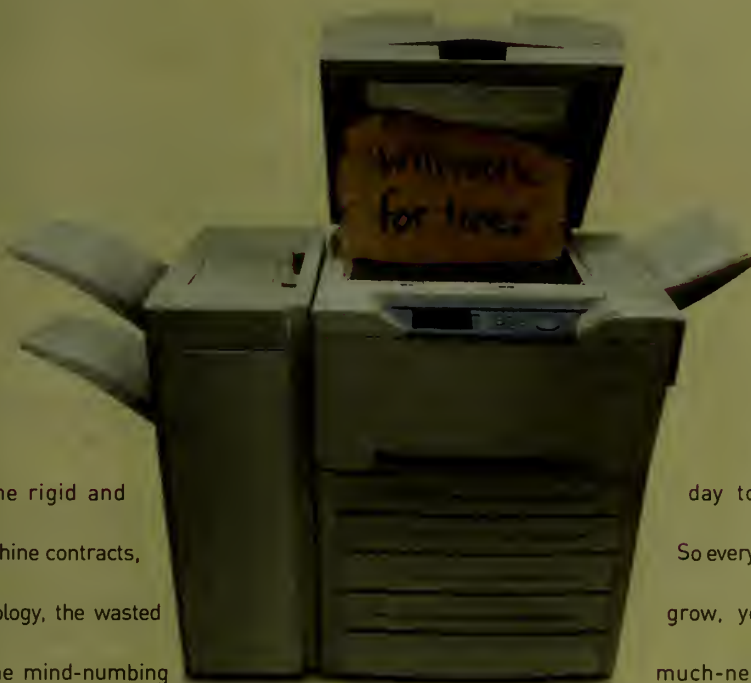
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Readers Report

IS MCKINSEY RESPONSIBLE IF ITS CLIENTS FAIL?

McKinsey did exactly what it was hired to do: help client executives formulate business strategies using sound psychology and economics, the foundations of marketing, finance, and all other business disciplines that increase the value of the client's organization ("Inside McKinsey," Cover Story, July 8). Client management had the fiduciary (key word) responsibility to select those strategies/tools that it believed would increase the firm's value, as measured by the stock price in most cases, without jeopardizing the future of the organization. No one should blame McKinsey for providing client executives with a diverse set of perspectives and options. Client management is responsible for executing those strategies.

Dennis Knueven
Columbus, Ohio

"Inside McKinsey" does not provide any evidence to suggest that McKinsey in any way contributed to the downfall of Enron, Kmart, Swissair, or Global Crossing. We now know that Enron's fall resulted from questionable practices.

We also know that Kmart continued to stay behind Wal-Mart in deployment of technology, management of supply chains, strategic alliances with major suppliers, and the product mix preferred by the consumer. Low prices and higher sales should have resulted from cost-effective procurement and operations—not from a price war. Regarding Swissair, strategy execution remains one of the weakest areas in many corporations. It should become a fertile area for academic research.

Kalyan Singhal
University of Baltimore
Baltimore

The consultants I've encountered in my 40-plus years in business (I'm now retired) usually have presented themselves as strategic thinkers. If the strategy fails, it's always due to poor execution, never to a flawed strategy. In my opinion, this is the standard cop-out for consultants, including McKinsey.

Martin Parker
Thousand Oaks, Calif.

As a longtime management consultant, I must take issue with your un-

derstanding of the management-consulting process. A company will frequently seek advice and then argue for the opposite conclusion. Or the company will partially implement your suggestions, often because it has sought advice from other professionals who provide conflicting advice. In addition, you ignore the political dimension. Frequently, the client has the right solution in-house, and the consultant merely resolves the internal conflict—with the added bonus that management doesn't have to take responsibility should things go awry.

Ira Davidson
New York

You ask, "What accountability does [McKinsey]—or any consulting firm—have for the ideas and concepts it launches into a company?" If in fact

McKinsey should share the blame because of the ideas and concepts it launched into Enron, then why stop there? Perhaps you should also blame the brilliant professors at the business schools from which McKinsey recruits many of its consultants and who may have taught the same concepts to Enron executives. On the other hand, perhaps blaming teachers for the scandalous actions of

their students is a pursuit not worthy of *BusinessWeek*.

Christopher John Davison
Ponte Vedra Beach, Fla.

Your "McKinsey over the years" photo timeline shows a picture of Marvin Bower. Apparently, the picture was not taken in 1933, as the caption indicates. The automobiles behind Mr. Bower look more like 1938 models.

William K. Sharpe
Las Vegas

CORPORATE SCANDALS DRAW ADVICE AND DISSENT

Bruce Nussbaum's essay "Can trust be rebuilt?" ("Scandals in Corporate America," Special Report, July 8) says "Boards of directors are firing CEOs left and right." But these fired CEOs are walking away with golden parachutes paying them more money for being fired than most Americans earn in a lifetime. Such actions continue to destroy, not rebuild, trust.

John Mitchem
San Jose, Calif.

As a result of the well-publicized failures of Enron, Global Crossing, Com, and other companies, Congress is formulating legislation to strengthen standards pertaining to accounting and auditing practices for public companies. The simplest and most effective way to deal with this problem is to empower the Securities & Exchange Commission to select the firms that audit and certify the financial records of any company that is allowed to sell stock to the American public.

Under this regulatory scheme, any company that wanted to sell stock to the American public could hire any accounting firm of its choosing. A company's financial statements prepared by a public corporation and its accounting firm, however, would be subject to review and certification by an independent auditing firm appointed by the public corporation would simply have to accept the fact that this was the price of admission to the stock market.

This is essentially a free-market solution that would create a well-balanced system of checks and balances, like the division created between pharmacist and doctors to help regulate the medical profession.

Robert
Oak Brook, Ill.

"Surprise! The little guy loses" (Special Report, July 8) cites a Lippman analyst commenting that retail investment funds operated by Eaton Vance and other mutual-fund providers have now learned that these funds have a large materiality in the senior, unsecured debt of WorldCom. With regard to Eaton Vance, this implication is inaccurate. Approximately 98% of the loans in Vance's portfolio are senior and secured. WorldCom has never been a holder of such debt.

James B. F.
Chairman and CEO
Eaton Vance

PHARMACIA: THE SCIENCE ON CELEBREX IS SOUND

We strongly disagree with the conclusions of Paul Raeburn's commentary "The credibility gap in research" (Science & Technology, July 24) regarding Pharmacia's Celebrex (celecoxib capsules) and the study referenced. The commentary focuses on a single endpoint of one study and completely ignores other important and meaningful results from that study.



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Readers Report

served to deprive your readers of the rich clinical data and good science—based on extensive clinical studies involving more than 30,000 patients—that support the safety and efficacy of Celebrex. Equally disturbing, this commentary implies that findings from the study in question that were published in the *Journal of the American Medical Association (JAMA)* were selectively chosen to favorably compare Celebrex to other nonsteroidal anti-inflammatory drugs (NSAIDs) involved in the study. In fact, the study's executive committee of external authors carefully considered the unexpectedly higher drop-out rate among study patients taking NSAIDs compared to those in the Celebrex group, and they determined that the safety analysis published in *JAMA* was the most meaningful and appropriate.

Pharmacia stands by the improved upper-gastrointestinal safety profile of Celebrex as reflected in the new Food & Drug Administration-approved Celebrex label and the positive impact Celebrex has had for millions of patients worldwide.

G. Steven Geis
Group Vice-President
Clinical Research
Pharmacia Corporation
Chicago

AN APPRECIATION OF FIDELITY'S BOB POZEN

We are managing, or have managed, billions of dollars in equity assets for Fidelity Management & Research Co. Contrary to the insinuations in the article "Here Comes Abby" (Finance, July 8), Bob Pozen was an outstanding president of FMR. While he brought more discipline, Bob let each portfolio manager pursue his or her own investment approach. He encouraged debate and discussion rather than imposing one viewpoint. Although trained as a lawyer, Bob quickly learned the investment process and used that knowledge to provide us with any help and support we needed to do a better job.

Robert Stansky
Steven Kaye
George Vanderheiden
Stephen Petersen
Boston

BEGGING TO DIFFER WITH TYSON ON TAX CUTS

"Tax cuts for the rich are even more wrong today" (Economic Viewpoint, July 8) is distorted, prejudiced, and incorrect. Laura D'Andrea Tyson says that

"over the decade, these Americans will enjoy an average tax cut of \$342,000 per taxpayer, draining \$500 billion from the federal budget," and "in 2010, the tax cuts passed by Congress last year will shower \$121 billion in tax relief on the wealthiest 1%." One sure way to exaggerate your case is to use "over the next 10 years" or "in the year 2010" because I can absolutely guarantee you that no one knows what the economy will be 5 years from now, let alone 10. So this way, you can pick the biggest numbers imaginable. What about using "based on last year's tax collections" to bring the article back to earth?

I think Ms. Tyson is using the top 100 or so taxpayers in the country to distort her averages and then projecting these numbers over 10 years out into never-never land to try to build resentment against the Bush tax cut. As a small-business owner with a lot of bills, I pray that the tax cuts take effect.

Peter J. Hess
President
Albany Steel Inc.
Albany, N.Y.

STATE ATTORNEYS GENERAL TOUCH A NERVE

I was disappointed in "White knights or loose cannons?" (Legal Affairs, June 17) about state attorneys general. It appears that these bureaucrats have determined that the way to get extra revenue for their respective government organizations and gain publicity as individuals is to penalize companies without due process, whether justifiable or not.

I don't know the statistics, but I am sure there are many more businesses subjected to these inequities than there were five years ago. If these trends continue unchecked, we will surely see a negative impact on productivity and performance. The bureaucrats need to recognize that companies are not just faceless entities but rather groups of real people trying to do the best for themselves and our great country.

John Yaukey
Prescott, Ariz.

CANADA REALLY IS FOR THE BIRDS —AND OTHER WILDLIFE

William Snape III's letter "U.S. timber tariffs help Canadian forests—a little" (Readers Report, June 24, regarding "Bush: What price fast track?," News: Analysis & Commentary, June 3) repeats inaccuracies about Canadian environmental practices.

The level of cooperation on wildlife-

management issues between Canada and the U.S. has been unparalleled since 1916, when the Migratory Bird Convention Act was signed. The agreement, coupled with the 1984 American Waterfowl Management Act, stands today as an example to the rest of the world of cooperative wildlife management and habitat conservation.

The 1997 Framework for Cooperation was put in place for the protection and recovery of wildlife at risk. The goal of this agreement is to prevent populations of wildlife shared by the U.S. and Canada from becoming extinct as a consequence of human activity. These are but only some of the many programs Canada has that protect cross-boundary species and ecosystems.

Peter M.
Minister, Political & Public
Affairs
Canadian
Government
Ottawa, Ontario
Canada

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SNOBBERY

The American Version

By Joseph Epstein

Houghton Mifflin • 274pp • \$25

NEW SIGNPOSTS FOR STATUS SEEKERS

Who among us doesn't harbor the memory of a snob inflicting upon us what we would call a snub? Over matters big or small, grammatical, genealogical, or enological—in the best schools or in remote backwaters—snobs parade, lurk, smirk, and pounce. A few years ago, I was fishing in a remote part of Maine, and after hours of unfruitful casting with a local streamer pattern, I tied on a wet fly popular in California. I almost instantly landed a nifty salmon. A pipe-puffing local stomped (well, sloshed) over to me, demanding to see my lucky fly. "Some of these damn fish," he harumphed, "will go after anything."

I believe essayist Joseph Epstein, author of *Snobbery: The American Version*, would agree that this wadered bloke needn't have been a Vanderbilt to qualify as a full-blown snob. In attempting to make me feel I had flung the piscine equivalent of a McDonald's Happy Meal on his sacred waters and deservedly caught the dumbest fish in the pond, he represented what Epstein calls "the essence of snobbery"—that being "arranging to make yourself feel superior at the expense of other people."

Epstein's book is about the origins, the essence, the nuances, and the modern variations on the age-old art of the scornful put-down, the superiority complex, and the exclusionary tactic. Its somewhat thin premise is that ever since the fall of classic snob accoutrements such as debutante balls, the society page, and other affectations of the WASPocracy in the U.S., snobbery has been adrift. It has settled in such realms as food, wine, fashion, education, and political correctness, there to contend with ever-roiling currents about class and taste rather than being anchored to simple breeding.

There's plenty of artful writing and thought here, and Epstein's wit makes

even the excess historical padding and linguistic hair-splitting palatable. The French, we learn, were already well-stocked with words to describe the pathetic mortals cavorting at the far, low end of an aquiline nose—*parvenu*, *arriviste*, *nouveau riche*. Later they embraced "snob" as well because, Epstein notes, quoting a French writer, the word had such a nice "*impertinence monosyllabique*."

But frankly, Epstein seems mainly to be seeking a venue to trot out all kinds of arch observations and delicious examples of a subject that has captivated him from a young age. The crown jewel of this collection involves a visit to Northwestern University by Diana, Princess of Wales. "Royalty in close proximity seems to make Americans lose their balance, if not get positively goofy," Epstein writes. He witnessed the university's president, "a smallish man in glasses" following Diana around chattering incessantly and reminding Epstein of "a chihuahua attempting to mount an Afghan hound."

Epstein says he has been a "statustician" since he was a schoolboy. He was born in Chicago to "culturally lower middle-class" Jews who he says weren't snobbish at all. He nonetheless writes: "Because I had in those days a superficial charm that allowed me to make friends easily, I was soon invited to join the best of the clubs and fraternities..." Geez, Joe, hate you already.

Preening aside, Epstein deserves a tasteful medal for bravery here. It's with no small amount of self-consciousness that you write or read—or, jeepers, review—a book on snobbery. But it's fascinating to me that while the book is

self-referential and Epstein offers plenty of evidence of his own affectations (he likes Jaguars and fitting raincoats; can't stand Henry Mancini), he never admits behavior or deficit or preference earned him a scorn that truly. He addresses anti-Semitism in terms of snobbery, for example, but is most concerned with assuring the reader that he really didn't take on minor experiences, which he might have imagined, too personally. Personally, his own snobbery is annoying. He fusses over his pleasure in his son's having been accepted at Oxford, for example, having already advised him that "you will at least have to spend any further portion of your life in a condition of yearning

thinking to yourself only I had gone to the better school, much grander than I would have been." I'm sure how that drooping ale makes him different from every other snob.

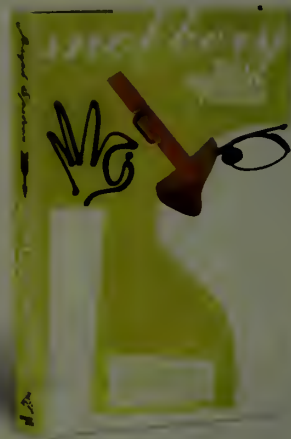
One glorious attraction of this book is that it takes a mincing step in the direction of self-help for snobbery-afflicted. It reads like a chorus line of wonderful observational

examples—such as the description of a whose style of living was "Pratt two dogs," or the discovery that the International Croquet Assn. requires any croquet set under \$300 as a child's set." Epstein also proffers quotes the way Doc Holliday dealt with aces, such as H.L. Menckel's definition of a wealthy man: a fellow who earns \$100 more than his wife's husband.

All these gems add up to a fairly funny read, ultimately more of a intellectual stand-up routine than a logical treatise. Perhaps I could use more generous words for Epstein hadn't taken such a nasty swipe at his hometown of San Francisco and its "richly, profoundly off-putting" natives are. Poor dearie, if only he were born here I might take him seriously.

BY JOAN O'C. HAMILTON

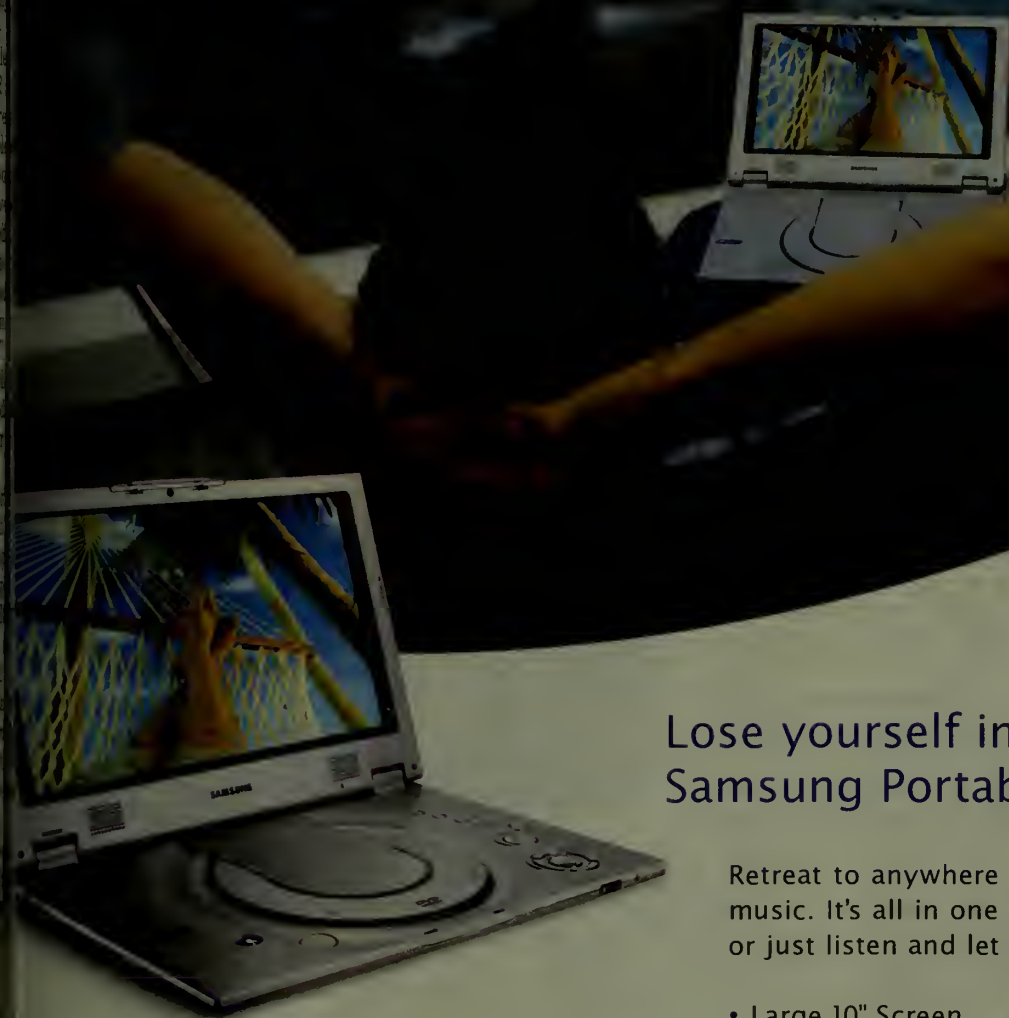
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BY ANDY REINHARDT

tech&you@businessweek.com

SAY CHEESE—THIS PHONE HAS A CAMERA



The Nokia 7650 not only is a lot of fun but as close as the wireless Web gets to living up to its potential

After 15 years of covering technology, I've become more than a bit jaded about the latest whiz-bang products. So it came as a surprise and pleasure to be bowled over by a new gadget du jour, the Nokia 7650 camera phone. Naturally, this sleek handset lets you talk and send text messages. But it also takes decent snapshots that you can send wirelessly—with an attached sound clip, if you wish—to other phones and e-mail addresses. Moreover, it plays music files, supports downloadable ring tones and tiny applications, and comes with built-in infrared and Bluetooth technology for communicating with other phones and PCs.

I can't recall when I've had so much fun trying out a product. Far from the usual frustrations I experience with cutting-edge technologies, I found the 7650 incredibly easy to use. Most important, as with other well-designed consumer electronics, I grasped immediately what it is best suited for. Only minutes after sauntering into Central London with the phone eagerly clutched in my hand, I had dispatched a recorded message to a friend: "Here I am in Trafalgar Square," linked to a photo of myself standing below a bronze lion guarding the base of Admiral Nelson's column.

Alas, my enthusiasm for Nokia's newest gizmo isn't universally shared. While companies are racing to bring out camera phones, many analysts remain skeptical of the potential. Not without reason:

The 7650 costs over \$750—about the same as a cheap PC—and could still run \$500 even after subsidies from operators. Nor can anyone predict whether this will be merely a fad that passes once the novelty wears off. In Japan, nearly half of all new phones sold already contain cameras, but many cus-

tomers don't appear to be using the

Such concerns aren't stopping Nokia is banking on imaging to fuel sales. too, are hoping for a boost from multimedia support in Britain was I Telekom's T-Mobile unit. By this fall, European and U.S. carriers will have multimedia support, and picture phones from Nokia are expected to be hot items at

Nokia has raised the bar with the 76

a color screen and graphic face, the 5.4 oz (154 gram) fits in a pocket and feels built. When closed, it's a bit wider than most contemporary handsets. To take a photo, open a recessed keypad to reveal the lens on the phone's backside, frame the shot on the screen, press a shutter. With 3.0

memory, the phone can hold dozens of pictures (the number depends on their resolution) plus hundreds of contact names and calendar entries. If you don't want to send pictures right away, it's a snap to save them to your PC later.

What if your desired recipient doesn't have a multimedia phone, or has none at all? Nokia was careful not to exclude folks. Pictures can be sent to an e-mail address. Owners of phones get a text message directing them to a Web site where they can supply I.D. and password

to see and hear for free what you sent. On T-Mobile's service, this worked flawlessly. Using the 7650 was the closest I've ever felt to experiencing the true potential of the wireless Web.

It's important to note that the 7650 isn't intended to take the place of a real camera. It has a fixed focal-length lens, no flash, and a top resolution of 640 by 480 pixels—about one-tenth the resolution of high-end cameras.

Such limitations raise the question of how many people will buy these phones. Nokia says that the point: Although cam-phones are a novelty, they will someday spawn a new way of communicating that's different from traditional photography or talking over the phone.

Maybe my enthusiasm is just the

born-again geek. I'm inclined to think The Nokia 7650 may be the final vanguard of camera-phones. It will help usher in a new era when mobile imaging is a part of life.



THE 7650:

Will the novelty wear off?

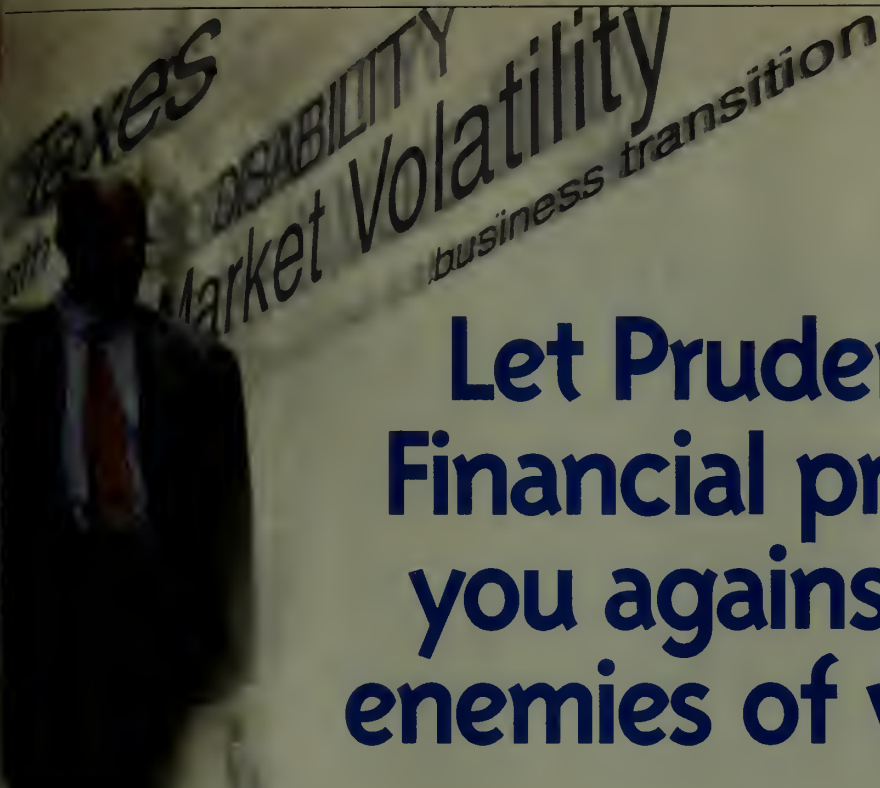


FROM LONDON:

"Yeah, as you can see, I shaved the beard..."

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BY ROBERT KUTTNER

TODAY'S MARKETS NEED A WHOLE NEW SET OF RULES



DAMAGE:
Regulations from the '30s couldn't stop the scams of the '90s. So Congress needs to go far beyond simply cracking down on miscreants

America's financial markets are in a tail-spin, chillingly reminiscent of the 1930s. What's similar is not the depth of the bust—our economy has far more stabilizers now than in 1929—but the self-dealing that led to the misallocation of trillions of invested dollars, the absence of necessary regulation, and the ensuing collapse of investor confidence.

How could this have happened again? The common element in the two eras is the conflicts of interest that benefitted insiders. Contrary to Chicago School economic theory, market forces were not able to detect, or to discipline, this opportunism. The culprits include: auditors who had become the servants of managers rather than of shareholders; brokers serving their own accounts rather than offering dispassionate advice to investors; bankers who put aside fiduciary duties to cut deals with dubious investment partners; directors who were subservient to CEOs rather than vice versa; and executives who put their own short-term enrichment through stock options ahead of creating wealth for shareholders. Although many of the particulars are new, all of these abuses echo the 1920s.

Despite President George W. Bush's contention that some corrupt individuals failed the system, it is the newly deregulated system that failed. This reality overturns a generation's conventional wisdom about the efficiency of free markets. In theory, markets capitalize all available information. Hence, prices are essentially accurate, investors discipline impostors, and regulation only retards the market's genius for spurring innovation.

But in each of the recent cases, market discipline and self-regulation failed utterly. It was just too easy to cook the books, pump up the stocks, and spread the gains around to the insiders. Markets were along for the ride, delighted as long as share prices kept rising. But markets were not competent to ferret out the fraud. And because of the prestige of the market and the low esteem accorded regulation, Congress would not permit the regulatory agencies to keep up with "innovations" that turned out to be scams.

It's true that 1930s regulation was not well suited to 1990s markets. But that's not because the New Economy no longer needs regulators; it's because the particular maneuvers of the '90s were not imagined in the '30s. Before the Great Crash, insiders used holding companies and other stock-watering schemes to bilk both investors and consumers. Banking houses combined brokerage, underwriting, and commercial banking

to sell securities to the gullible. More and more people invested "on margin." The prohibitions of the '30s blocked a repetition of abuses by regulating securities market activity, separating commercial banking from investment banking, the Glass-Steagall Act, limiting margin interest, and so on.

But by the '90s, a host of newly identified abuses overwhelmed the regulatory regime of the '30s. Who needs margin when you have derivatives? By the time Glass-Steagall was formally repealed, the creative breaching of the wall had become commonplace. So the lesson was not that "the genie can't be put back in the bottle." It's that naive worshipers of the market smashed the bottle, and that new generation requires new bottles. Despite Republican hopes, Bush will likely sign legislation separating consulting from consulting, toughening accounting standards, criminalizing new categories of fraud, holding CEOs personally accountable for false statements, mandating more independent corporate boards, and perhaps changing the rules for stock options. This will be adequate to prevent the next wave of such abuses, but new scams are devised. It remains to be seen how much damage has already been done to the real economy.

But the disgrace of the laissez-faire experiment calls for a much more searching reexamination of the market fundamentalism that has characterized this economic era. It isn't just that corrupt insiders were able to cook books and pocket illicit rewards. Deregulated markets allowed trillions of dollars to be used for purposes that will never pay back a penny. In industries like telecommunications, deregulation led to competitive overbidding and mergers that were sheer economic waste. The collapse of antitrust enforcement stifled a new wave of economic combination that had no purpose other than the concentration of market power and the enrichment of senior executives. The prestige of markets has lent credibility to for-profit social institutions—HMOs, day-care homes, schools, hospitals—with perverse incentives to maximize earnings by avoiding expensive cases and stinting on service.

Efficient capitalism is never built on a free market. Markets do many things well, but they aren't so good at policing themselves, locating resources in sectors that are natural monopolies or social goods. If Congress cracks down on the flagrant self-dealing that we have not learned enough from this vast field of economic damage.

Robert Kuttner is co-editor of *The American Prospect* and author of *Everything for Sale*.



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EDITED BY PETER COY

TAKING STOCK OF THE STOCKROOM

Inventory control has improved

During the 1990s boom, American companies bragged that new computer systems enabled them to manage their inventories better. They steadily reduced the amount of goods they kept on hand for a given level of sales (chart).

But companies' ability to manage in-



ventories seemed less impressive after they apparently found themselves with too much on the shelves during the mild 2001 recession. They rapidly liquidated goods on hand, culminating in the fourth quarter of 2001, when inventories plunged at an annual rate of \$114 billion. That was the biggest drop as a share of goods-sector output in more than 50 years.

However, a new study by two economists at the Federal Reserve Bank of New York concludes that, at least in the first three quarters of 2001, companies did a better job at managing inventories than in previous recessions. James A. Kahn and Margaret M. McConnell argue that companies reacted appropriately to slowing sales and "were shedding inventories from the outset [of the recession] in a calculated effort to avoid a heavy buildup of stocks." In a typical downturn, companies overaccumulate inventories because they don't manage to slash output as rapidly as sales are falling. This time, the ratio of inventory to sales remained close to target, the authors estimate.

The two Fed economists have a different explanation for what happened in the fourth quarter, when inventories really took a dive. They say that after coping with slumping demand, compa-

nies were caught off-guard by an abrupt sales surge and were forced to meet the demand by selling goods off their shelves. The authors estimate that nearly half of the fourth-quarter inventory drawdown was unintended.

Some economists have argued that such big inventory changes are a good thing because they buffer company production schedules against rapid swings in sales. They speculate that since the late 1980s, companies have gotten more systematic about deliberately using inventories as a damper against demand fluctuations. But that's not so, according to new, unpublished research by Massachusetts Institute of Technology economist Olivier Blanchard and graduate student Claudio Raddatz. Based on a statistical analysis, they conclude that there has been no permanent increase in the use of inventories to buffer sales fluctuations.

EXTRA RISK FOR TECH INVESTORS

When insiders are mum, watch out

Will tougher accounting standards stop company insiders from abusing the trust of investors? Not in high technology, says a new study by three researchers at the Center for Research in Electronic Commerce at the University of Texas at Austin. Investors in tech companies are even more vulnerable to manipulation by corporate insiders than investors in other companies, say researchers Xianjun Geng, Lihui Lin, and Andrew B. Whinston.

Relatively verifiable indicators of corporate worth, such as current profitability, are less useful in valuing tech companies, the Texas researchers say. That's because most tech companies are valued based on the long-term outlook for products and markets that barely exist yet. If insiders get wind of bad news, they can withhold it from investors until they already have dumped their own shares.

A loss of trust in tech will hurt the economy because both good and bad companies will be cut off from funding. It's an example of the "lemon" theory, which says that the market for goods of uncertain value won't function if people fear they will wind up with a lemon.

The researchers say that tech investors need other reforms in addition to those now being proposed. They suggest that tech insiders should be required to notify the public before they

sell shares, giving investors time to decide whether to sell shares first.

A DEFICIT TOO HIGH?

Trade figures aren't adding

Alarm bells are sounding as a current-account deficit continues to grow. But the fears may be overblown, a new paper by L. Douglas Lee, president of consulting firm Econometrics Inc. in Potomac, suggests that the current-account deficit was officially \$393 billion in 2001—too high by 50% or more.

Lee says U.S. exports are probably understated. One of the reasons, he argues, is the Internet. Wiping has increased the number of transactions valued at less than \$2, the threshold for reporting exports to the U.S. Customs Service. Automating doesn't track products across borders by individuals. Automates these so-called personal services rose in the 1990s, as borders with Canada and Mexico became more open.

Lee also notes that there is a consistency in the economic theory, the current-account deficit should match the net flow of foreign investment into the country. That, in turn, should theoretically be just enough to make up for the domestic savings shortfall, that is, the amount by which investment in the U.S. exceeds the savings generated within the country.

But government statistics show that the current-account deficit is much bigger than the savings surplus. In fact, the gap widened to an annual rate of \$207 billion in the first quarter (chart). At least a portion of the gap, Lee, reflects an overestimate of the trade deficit.

There's another hint that the deficit is overstated. Globally, the current-account surpluses and deficits of all countries should sum to zero. Instead, the global balance is a growing deficit. Lee thinks bad U.S. data is the biggest factor.

By Margaret Popper



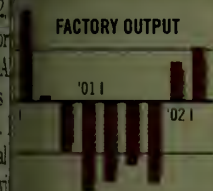
DON'T BLAME THE ECONOMY OR THE BEAR MARKET

Bedeviled by corporate scandals, investors are ignoring good news

U.S. ECONOMY

Here's a disturbing fact: After the September 11 attacks, the Dow Jones industrial average lost 6.8% of its value, not finding a bottom. Since news of the corporate scandals began to snowball in mid-May, the Dow is down 18%. In other words, corporate wrongdoers have done more than twice as much damage to the U.S. stock markets as Osama bin Laden.

MANUFACTURING IS ONLY ON THE MEND



PERCENT CHANGE,
ANNUAL RATES
Federal Reserve, DRI-WEFA

Nevertheless, the growling bear on Wall Street is in stark contrast to the industrious bees now at work in the economy. The latest data show the real economy is gathering a good bit of momentum going into the second half. In June, shoppers were buying with gusto, builders broke ground on an impressive number of new homes, and industrial output picked up (chart). After a shaky second quarter, real gross domestic product entered the third quarter with a good head of steam, even as the stock market was tanking. One reason for the disconnect: The tightening of financial conditions, exacerbated by the drop in stock prices, has been offset by a decline in long-term interest rates and a depreciation in the dollar. Plus, the Federal Reserve seems intent to leave short-term rates at their current stimulative level for the rest of the year.

It was much clear from Fed Chairman Alan Greenspan's semiannual testimony on monetary policy on June 16-17. While Greenspan's assessment of the economy was upbeat, he gave no hint that policymakers were close to lifting interest rates. He said that inflation contained and likely to remain so, the Fed would loosen to maintain its accommodative policy stance in response to demand by consumers and businesses is on a solid footing. That could take a while, Greenspan said, because the final demand has been increasing, the pace of which and momentum remains uncertain.

THE CLIMATE on Wall Street, Greenspan had to walk a tightrope. He needed to calm the financial markets for the sake of the economy, but he did not want investors to think the Fed would step in to rescue the market from a debacle that was not caused by the Fed. The Fed chief made it clear that recent spec-

ulation about a rate cut is wrongheaded. When questioned about a reduction by Senator Paul S. Sarbanes (D-Md.), Greenspan all but said it wasn't necessary because "the economy is improving."

Indeed, the Fed boosted its forecast for 2002 growth substantially, from a range of 2.5% to 3% in February to 3.5% to 3.75%, and it sees growth picking up in 2003 (table). Worth noting, Greenspan offered up positive remarks about the trends in productivity and profits, and he said that with the elimination of excess capacity now well advanced, "business fixed investment may be set to improve," although the pace will be gradual and uneven, especially in light of the telecom glut.

Greenspan alluded to the disconnect between the economy's encouraging prospects and Wall Street's skittishness, which could limit the economy's growth. Sounding more like a tent-revival preacher than a central banker, the Fed chief spoke at length about the corporate scandals, often with a rare eloquence stemming from his deep-seated belief that trust is a cornerstone of free markets and that free markets mean free flow of information, unencumbered by falsification and fraud. Greenspan railed against poorly structured stock options as a key source of "infectious greed" among too many executives.

THE LATEST DATA back up the chairman's optimism on the economy. Consumers hit the malls in June, with retail sales scoring a 1.1% advance, recovering all of May's decline. And early reports from car dealers for July suggest that buyers are responding to new zero-rate financing deals.

Despite the stock market's hit to recent consumer-confidence readings, gradual improvement in the job markets and income prospects appear to be outweighing market worries. Another reason: There are more homeowners than shareholders, and rising home values remain the most important source of household wealth. Consumer spending, which slowed in the second quarter, appears set to grow at a faster pace this quarter. That, plus the ongoing, albeit uneven, firming of capital

THE FED SEES AN IMPROVING ECONOMY

THE FED'S CENTRAL TENDENCY FORECASTS

	2001 ACTUAL	2002 FORECAST	2003 FORECAST
REAL GDP	0.5%	3.5-3.75%	3.5-4%
PERSONAL CONSUMPTION PRICE INDEX	1.3%	1.5-1.75%	1.5-1.75%
UNEMPLOYMENT RATE	5.6%	5.75-6%	5.25-5.5%

FOURTH-QUARTER TO FOURTH-QUARTER CHANGE, EXCEPT FOR JOBLESS RATE, WHICH IS FOURTH-QUARTER AVERAGE
Data: Federal Reserve Board

Business Outlook

spending, bodes well for a pickup in overall GDP growth.

A solid recovery is also increasingly evident in the industrial sector, where output in June surged 0.8%. Manufacturing production alone jumped 0.7%. Excluding an auto-industry distortion in 1998, the June rise in industrial production was the largest since 1997. For the second quarter, manufacturing output rose at an annual rate of 4.2%, the strongest quarterly showing in two years.

The production increase spans high-tech and low-tech sectors. In particular, output of high-tech equipment grew at an annual rate of 26.5% last quarter after a 23.7% gain in the first quarter, led by computers, office equipment, and semiconductors.

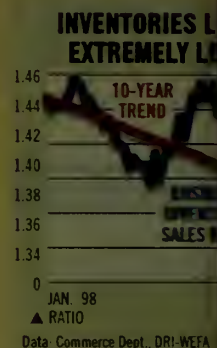
OVERALL PRODUCTION is picking up in large part because companies have cut their inventories so much that they risk losing sales if they don't beef them up. Inventories of manufacturers, wholesalers, and retailers rose 0.2% in May, the first increase in 1½ years. Still, the ratio of inventories to sales is well below its long-term trend, suggesting that stockpiles are lower than desired, a point corroborated by recent industrial surveys of customer inventories (chart).

Also, manufacturers have been given three lifts from the depreciation of the dollar since February. For starters, the cheaper dollar hikes import prices, helping factories compete in U.S. markets and providing cover to

nudge up their own prices. Two, it makes exports pricier in foreign markets. And three, it boosts profits of multinational operations when overseas earnings are translated into dollars, an impact that will begin to show up in second-quarter profit reports.

However, Greenspan advised investors to pay close attention to the Commerce Dept.'s accounting of overall corporate earnings. Commerce data exclude a number of one-time charges that show up in shareholder reports. They attempt to expense the value of stock options. Most important, the chairman said, they are "far less subject to the spin evident in reports to shareholders in recent years." Indeed, this measure of profits has looked very strong in recent quarters, reflecting strong productivity gains and declining unit labor costs.

Those trends underlie the chairman's cautiously optimistic outlook. The market's free fall still looks like a risk to the recovery. But Greenspan understands that Wall Street's woes are a product of human weakness and economic frailty. "It is not that humans have become more greedy," Greenspan said. "It's that the ability to express greed had grown so enormously."



CHINA

EXPORTS ARE A CONTINUING SOURCE OF POWER

China's economy is looking sturdy as the Communist Party prepares to name a new leader to succeed President Jiang Zemin. According to official data, real gross domestic product in the second quarter rose a surprisingly strong 8% from a year ago, up from 7.6% in the first quarter and from 7.3% for all of last year. Solid growth is set to continue, but not at the first half's blistering pace.

A 24.4% surge in investment by state-run companies in the first half, mainly for infrastructure projects, led last quarter's acceleration, but budget limitations could crimp the state's ability to boost growth in the second half. A 14.2% advance

in exports, helped by tax breaks, also provided a first-half kick, up from last year's pace. But further significant acceleration is unlikely.

Meanwhile, China is coping with deflation, partly reflecting new import competition after its December entry into the World Trade Organization. Consumer prices fell 0.8% in the first half, but the trend is easing. China's central bank is allowing the money supply to grow above its 14% target.

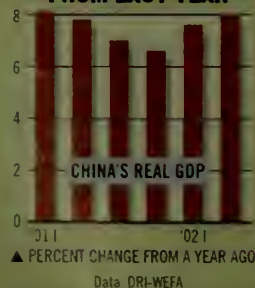
Despite these headwinds, the economy should be able to maintain at least a 7% pace in coming quarters. That's barely enough, however, to absorb new entrants into the labor markets. Unemploy-

ment is far higher than the official count, but recent strong growth appears to be limiting new joblessness—and social unrest.

Set against China's growing role as a global manufacturing base, exports will continue to power the economy as manufacturers from other countries see their primary processing on the mainland. WTO entrance is a further boost for foreign direct investment (FDI), which is allowing China to capture more market share from its Asian neighbors. Contracted FDI, an indication of future investment flows, jumped 31.5% in the first half.

Moreover, since the value of Chinese yuan is tied to the U.S. dollar, the dollar's depreciation since February gives China an added trade advantage, especially over Japan and South Korea.

GROWTH HAS PICKED UP FROM LAST YEAR





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THE ANGRY MARKET

THE BLUNT MESSAGE: *Investors are repricing stocks to reflect a more honest picture of earnings, options, and the future.* **ULTIMATELY, THAT'S GOOD.**

BY ANTHONY BIANCO

Markets are fragile things. They depend on a confidence that accumulates gradually but can be shattered suddenly. Our financial markets survived the devastating attacks of September 11 as the nation rallied to the banner of aggressive self-defense. But in recent weeks, an epidemic of corporate scandal seems to have picked up where Osama bin Laden left off, demoralizing investors and threatening the economic recovery. Wall Street and Washington now are embarked on what amounts to nothing less than a restating of the 1990s. The markets will be a long time sorting through the economics of corporate reform. In the meantime, investors should find solace in the hope that the next bull market will rest on a solid foundation of reality.

Some \$7 trillion has vanished since the market peaked in March, 2000, but it seems that only in the past week or so has it dawned on most of us that no one—not George W. Bush, not Alan Greenspan, not even Warren E. Buffett—has the power to prevent the further depletion of America's retirement accounts. There was a whiff of panic in the air on July 15, as the Dow Jones industrial average plummeted 440 points, only to abruptly reverse course and rise 400

points in the last hour and a half of trading. Some strategists argue that this kind of convulsion in the market is a classic sign of the beginning of an end of the market. They might be right, but there has never been less classic than the one that afflicts us now.

Start with the cataclysm of September 11 and the economic and political uncertainties it has engendered: the prospect of a full-bore war with Iraq not least among them. It took only one horrific day to shatter the nation's faith in its security in an increasingly hostile world. The discrediting of the American corporation took longer.

The notion that every high-tech and telecom cast to the sky collapsed well before September 11, when the market was pressing the market. The destruction of the World Trade Center sent share prices into a tailspin, but they quickly rebounded and then some on a wave of patriotic fervor and relief over the U.S. military's resounding early victory in Afghanistan. The national preoccupation with finding bin Laden and the free-floating terrorist menace—What and when?—delayed Corporate America's day of reckoning. It wasn't until the lid was pried off Enron Corp. last year that the market began dealing in earnest with the unsavory underpinnings of the speculative mania of the 1990s.

Enron's transgressions were at once so flamboyant and so arcane that at first, the company could plausibly be dismissed as an aberration—a "bad apple," in the President



gy. But the scandals
 pt on coming: Arthur Ander-
 lobal Crossing, Xerox, Adelphia Com-
 ations, Tyco International, ImClone Systems. With
 ne, investor confidence took a hit, yet calls for systemic
 continued to be sloughed off by corporate leaders
 e White House. The tipping point finally came in June,
 WorldCom Inc. admitted that it had magically con-
 operating expenses into capital costs, artificially boost-
 come by \$3.8 billion. The brazen artlessness of this
 e shook the market to its core and altered the political
 s in Washington virtually overnight.
 ounting issues have periodically bedeviled the stock
 t, but never so pervasively as they do now and never
 ore ticklish time. At this point in the business cycle, the
 ount question for investors should be: "By how much
 rporate earnings rise?" Instead, it is: "Are anyone's
 gs real?" Actually, these two questions are linked in
 hat might continue to roil the markets for months. The
 ia is this: Many of the same corporate reforms that are
 to restore investor confidence will depress earnings—
 ocks—at least in the short term.

Take the sud-
 denly hot issue of stock-
 option accounting. It's easy
 for an accountant to make a case
 that options are an expense and
 should be recognized as such on the books. This argument
 stood little chance when options were making executives filthy
 rich, but its time appears to have arrived, some 17 years after
 Buffett began championing it. In the past week, two companies
 closely associated with Buffett—Coca-Cola Co. and Washington
 Post Co.—as well as Bank One Corp. announced that they will
 start expensing options. If all of the companies in the Standard
 & Poor's 500-stock index had expensed options in 2001, their
 earnings would have declined by 24.5%, says S&P.

In many ways, companies have already begun to embrace
 more conservative accounting methods, often with little fan-
 fare. When CEOs have to personally vouch for their companies'
 financial statements, as they must start doing on Aug. 14, it's
 a good bet that they will play it safer than they did in the
 1990s, even if it shaves more than a few cents off of earnings
 per share. Boards are now equally motivated. With investors
 and politicians alike demanding better governance—and real
 consequences for directors who don't deliver it—audit com-
 mittees suddenly are snapping to attention.

Here's an idea: Wouldn't we all be a whole lot happier if we
 not only admired (and envied) Warren Buffett but truly took
 the Sage of Omaha as an investing role model? We would buy
 only the stocks of companies we understood and believed
 in, and we would hold tight to their shares through thick and
 thin. We would closely follow the news but never be un-
 nerved by it. We would acknowledge the likelihood that the
 stock market will not outperform the economy over the com-
 ing decade as it did in the 1990s—and we would welcome this
 as a return to common sense. ■

Special Report

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SPECIAL REPORT The Angry Market



2PM

Bernie Ebbers
ex-CEO of
WorldCom, tak
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House commi
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company for f

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time for corporate
criminals and
more funding for
the SEC in a
speech on Wall
Street

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A WEARY BROKER ON THE FLOOR
OF THE NEW YORK STOCK
EXCHANGE ON JULY 16

THE GOOD NEWS ALL THAT BAD NEWS

Uninformed cleansing taking place could usher in a stronger, healthier market

On July 15, Nan Hudes, a marketing director at a New York publishing company, made one of the toughest decisions of her life. At about 2:15 p.m., after watching the Dow Jones average nosedive by more than 100 points, she sold all of her stock except those in one small 401(k) plan. "I just couldn't take it any longer," says Hudes, a grandmother in her 60s. Her net loss: about \$100,000. She plans to use the money to retire in three years. She immediately put her remaining assets into bond funds and cash. "I'd be much less upset if I was 40 and had to make that money back. At this age, forget it. It's gone." As investors become more and more disenchanted with equities, the market continues to suffer one of the most vicious sell-offs in memory. The Nasdaq and

Standard & Poor's 500-stock index are back to 1997 levels, wiping out \$7 trillion in value from the market's peak. And the Dow has dropped to its lows of late last September. It's the Dow, in particular, that has investors worried. The index, which consists mainly of Old Economy, more stable companies, had held up better than the rest over the past nine months. But through July 16, it fell seven days in a row, losing almost 10% of its value.

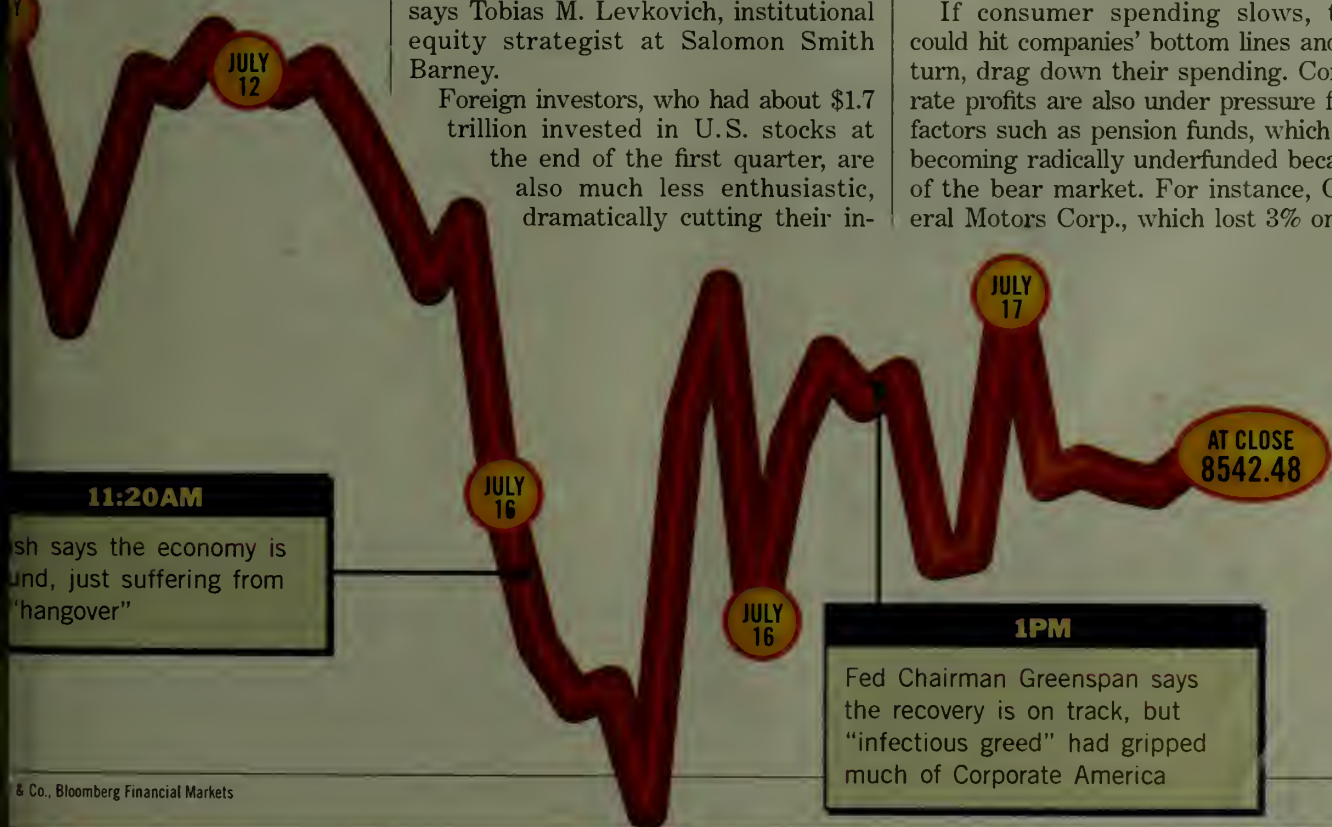
Millions of investors are reeling from their losses. In a July 9 survey by the American Assn. of Individual Investors, 42% of respondents said they're bearish and 35% bullish. That's an about-face from January, 2000—just two months before the Nasdaq crash—when only 13% were bearish and bulls hit an all-time high of 75%. And a recent Gallup poll found that people's trust in corporations has fallen to a new low. "We've gone from the democratization of equities to the demonization of equities," says Tobias M. Levkovich, institutional equity strategist at Salomon Smith Barney.

Foreign investors, who had about \$1.7 trillion invested in U.S. stocks at the end of the first quarter, are also much less enthusiastic, dramatically cutting their in-

vestment here. That's partly due to the weak dollar: As foreigners see shrinking returns on dollar-denominated assets, they put less money in U.S. stocks and take more home, worsening the market's decline. European insurers and pension funds, in particular, are under pressure to dump U.S. equities.

The stock market rout could begin to take a toll on the economy. Although it has remained amazingly resilient, Federal Reserve Chairman Alan Greenspan said on July 16 that the economy may not recover as fast as expected because of wounds from corporate scandals coupled with the severe drop in stocks. Also, while consumer spending has held up so far, it could start to slow because of stock market losses. Investors such as Hudes, whose net worth has more than halved, are simply spending less. "When I had all that money, I was more than happy to spend it. Let's just say Saks Fifth Avenue got a lot of it, but not now," she says.

If consumer spending slows, that could hit companies' bottom lines and, in turn, drag down their spending. Corporate profits are also under pressure from factors such as pension funds, which are becoming radically underfunded because of the bear market. For instance, General Motors Corp., which lost 3% on its



pension investments this year, will have to plow \$9 billion into its fund over the next five years to comply with accounting standards. Says GM Vice-Chairman and CFO John M. Devine: "We aren't looking for the market to bail us out." Then there are stock options. If companies follow Warren E. Buffett's advice and start expensing them, their bottom lines will suffer another blow.

Yet the gloom is so widespread that many investment strategists are taking heart. For starters, it means the Federal Reserve is unlikely to raise interest rates for six months or more. Even better, they say, investors are so discouraged that they're sending a strong contrarian signal that the market may turn up soon. "Assuming the earnings rebound in the third quarter, as we expect, this could mark the beginning of the bottoming for stock prices," says Edward M. Kerschner, chief global strategist at UBS PaineWebber Inc.

But for now, people are cashing in equities like crazy. Investors started bailing out of stock mutual funds in June. With the exodus accelerating in early July, funds are now facing a crunch: Redemptions mean that managers don't have enough cash to buy stocks even if they want to. "The outflows could put a damper on the market for some time to come," warns Thomas McManus, chief investment strategist at Banc of America Securities. According to Trim Tabs, which researches money flows, there could be \$59 billion in outflows in July—far more than was pulled out after September 11.

Some of the biggest mutual funds are caught in the squeeze. Janus Fund had \$25.6 billion in assets, including \$300 million in cash, at the start of the year. But investors pulled out \$1.6 billion through May 31, according to Financial Research Corp. What's more, "there's a concern that equity flows might not turn back as fast as they have in the past with a market rebound," says analyst Robert Lee of broker Keefe, Bruyette & Woods. The reason: Most of those cashing out are investors nearing retirement—who control the largest amount of assets.



Large mutual-fund redemptions aren't the only force driving the market south. Institutional traders, especially hedge funds, are playing havoc with already troubled stocks. "Hedge funds are very active, very aggressive in this market," says Laszlo Birinyi of Birinyi Associates Inc. Birinyi, who studies money flows, thinks hedge funds could account for as many as one out of four trades. "This is the crowd that has to figure

GONE Many of cashing out are nearing retirement and are less likely to return in a rebound.

out ways to make money in any market environment," says Bernard Schaeffer, president of Schaeffer's Investment Research Inc. in Miami. And because funds tend to short and play big in options, they exert intense downward pressure on the market.

Some market players say hedge funds are adding to sky-high volatility and some of the wild price swings by spreading negative rumors after they've shorted. Short-sellers have also fared this tarnished reputation. But in this market, the claim may hold more

weight. Investors who are already skittish over tales of corporate malfeasance and market declines are dumping shares at the first whiff of trouble, real or imagined. "The portfolio manager who has put ten his head handed to him or her," and Tyco is just saying, "Get me out of here, I don't care if it's true," says Scott Sanford C. Bernstein & Co. analyst. In fact, trading in General stock was halted on June 26 after

a massive sell-off of which were proved untrue the stock.

Investors have undergone a psychological shift. Banc of America's McManus says there's a "dip" in the market, so popular in the past has given way to mantras: "Pre-market stocks to go" and "even after hit bottom, retreating likely to remain par for many." During the '90s stock bubble, it was stocks only w. Now, the opposite is true. "The market is feeding on itself."

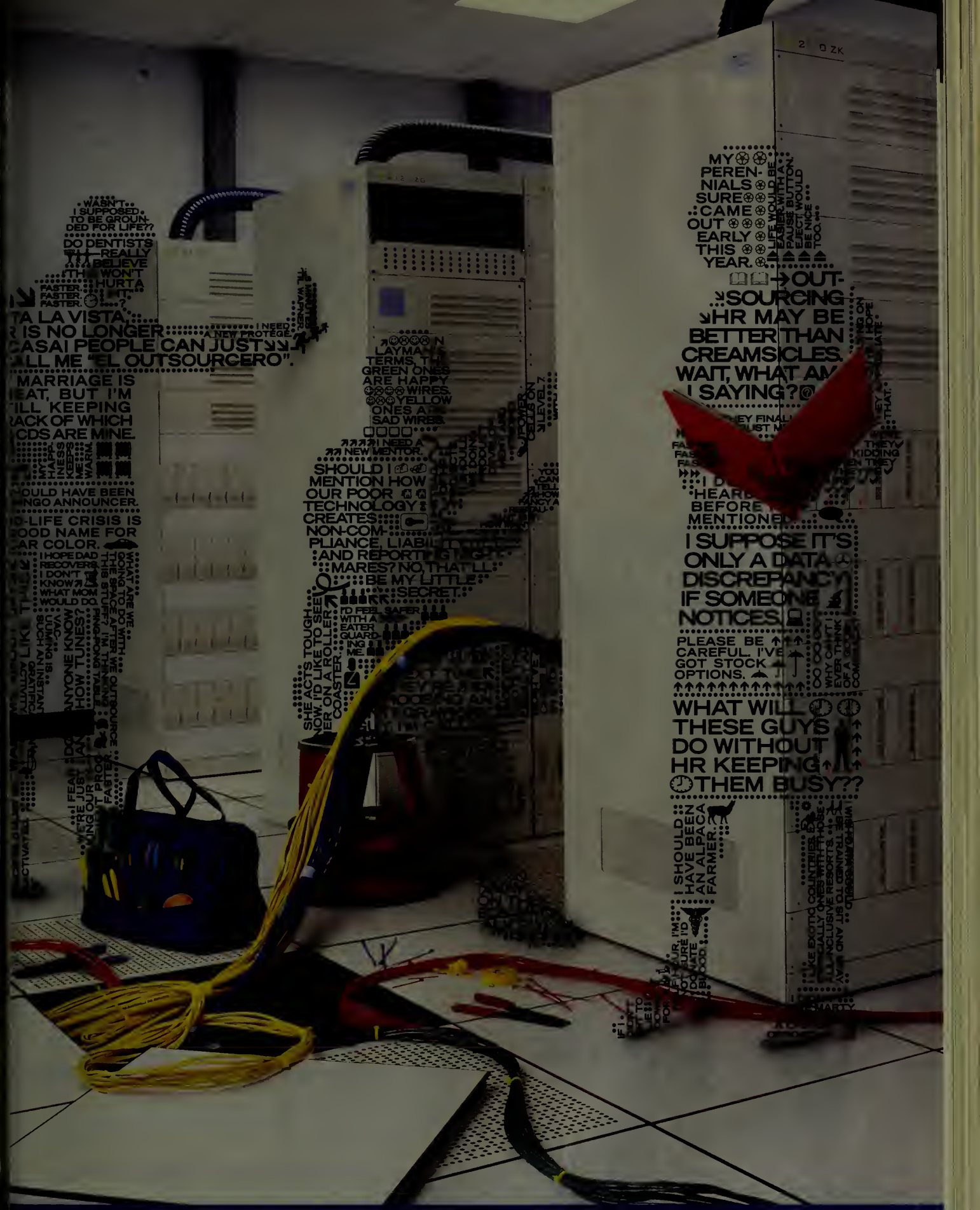
How Big A Hit?

If options were expensed, the impact would be largest at these companies:

Data: Bear Stearns & Co. estimates

	2001 NET INCOME	2001 NET INCOME MINUS OPTION EXPENSE*
IN MILLIONS		
MICROSOFT	\$7,721	\$5,459
CISCO SYSTEMS	(1,014)	(2,705)
NORTEL NETWORKS	(24,307)	(25,953)
AOL TIME WARNER	(4,921)	(6,352)
IBM	7,723	6,484
INTEL	1,291	254
LUCENT TECHNOLOGIES	(14,170)	(15,144)
YAHOO!	(93)	(983)
MERRILL LYNCH	573	(281)
SIEBEL SYSTEMS	255	(467)
HEWLETT-PACKARD	624	(65)
BROADCOM	(2,742)	(3,408)
J P MORGAN CHASE	1,719	1,097

*After taxes. Assumes 40% effective tax rate unless otherwise reported.



WASNT I SUPPOSED TO BE GROUND FOR LIFE?? DO DENTISTS REALLY BELIEVE IT? WONT HURTA IT? FASTER FASTER FASTER?

LA VISTA... IS NO LONGER CASAI PEOPLE CAN JUST CALL ME "EL OUTSOURCERO".

MARRIAGE IS MEAT, BUT I'M WILL KEEPING RACK OF WHICH CDS ARE MINE.

OULD HAVE BEEN WINGO ANNOUNCER. D-LIFE CRISIS IS GOOD NAME FOR AR COLOR.

I HOPEDAD RECOVERED I DON'T KNOW? WHAT MOW? WOULD B D

ANYONE KNEES? HOW TUNES? DO ANYONE DO

FEAR I AM HERE JUST WING OUR IT FASTER, FASTER, FASTER.

N LAYMAN'S TERMS, THE GREEN ONES ARE HAPPY. WIRES. YELLOW ONES A SAD WIRE.

NEED A NEW MENTOR. SHOULD I MENTION HOW OUR POOR TECHNOLOGY CREATES NON-COMPLIANCE, LIABILITY AND REPORTING MARES? NO, THAT'LL BE MY LITTLE SECRET.

SHE ACTS TOUGH NOW, I'D LIKE TO SEE HER ON A ROLLER COASTER. TO FEEL SAFER WITH A EATER GUARD. ING E ME

MY PERENNIALS SURE CAME OUT EARLY THIS YEAR. OUT-SOURCING HR MAY BE BETTER THAN CREAMSICLES. WAIT, WHAT AM I SAYING?

HEY FINALLY JUST MENTIONED I SUPPOSE IT'S ONLY A DATA DISCREPANCY IF SOMEONE NOTICES.

PLEASE BE CAREFUL I'VE GOT STOCK OPTIONS. WHAT WILL THESE GUYS DO WITHOUT HR KEEPING THEM BUSY??

I SHOULD HAVE BEEN AN ALPACA FARMER.

LIKE EXOTIC COLONIES? Specially ones with house all inclusive resorts. ANY ANY JIS OL GENIVALL SEX OTHERS MAY GET

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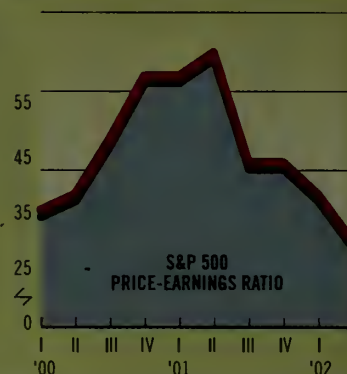
downside just as it fed on itself on the upside for seven years," says Barry Hyman, chief investment strategist at Ehrenkrantz King Nussbaum. Indeed, "suckers' rallies"—when stocks soar for a day, then dramatically drop—are depressingly frequent now. "You get these upward trends, but they never hold. People are so shaken by these company scandals. We need some certainty—some good earnings numbers," says Robin Dayne, a trading coach in Las Vegas.

Actually, profits have already started to turn up. According to Thomson Financial/First Call, S&P 500 earnings are expected to rise 3% this quarter from a year ago. And because year-over-year comparisons will be based on last fall's depressed profits, third- and fourth-quarter earnings should start looking much

PRICE-EARNINGS PANDEMONIUM?

The bear market has brought p-e ratios back to earth. But if companies start expensing options, earnings could drop by roughly 20%, driving p-e's back up.

Data: Standard & Poor's



better—up 16% and 28% respectively.

But investors are still leery of the numbers—with good reason: If all S&P 500 companies expensed stock options, earnings would have been 24% lower in

2001 and will be estimated 17% lower this year. "Worries about the validity of the numbers have added to the charged emotional atmosphere of despair," says Kumar, chief investment strategist at World Market.

Could this get worse? Yes. For example, George W. Bush's demand that CEOs and CFOs voluntarily

numbers and purge them from their books. Companies won't be auditing their accounts a thorough until they prepare their next audited annual reports in the spring. Meantime, most executives will do their best, gulp hard and sign. Says accounting analyst Trevor Harris of Morgan Stanley: "If you've only got a few weeks to evaluate your past 10Ks and 10Qs, you don't have time to investigate everything."

Right now, there's no telling how many more delusions still lurk. The SEC won't decide whether all major corporate filings are up to snuff for months after Aug. 14. Besides, there's a big debate among businesses and accountants about the proper

EXPECT SURPRISES LONG AFTER AUGUST 14

The bulls have high hopes for Aug. 14—the Securities & Exchange Commission's deadline for the top executives of nearly 1,000 publicly traded companies to start swearing that their financial reports are on the level and accurate. Between now and then, the optimists are betting, the nasty stuff festering in company books will have to come to a head. And that could spark a stock market rally, based on company numbers investors can trust, in the fall.

Dream on. Aug. 14 is just the start of months of accounting revelations that are likely to feel more like extended root-canal work than a quick extraction. Experts estimate that companies in the Standard & Poor's 500-stock index overstated their earnings by upwards of 10% to 15% in most recent years, largely because they didn't count the cost of employee stock options and made over-optimistic assumptions about their pension plans. Once other sources of puffed-up earnings—as well as outright fraud—come out, the reduction in earnings could be much worse,

especially in the technology, cable, and telecom industries, which stretched their accounting the furthest.

Why will it take so long to drain this abscess? First, Aug. 14 isn't the big day for everyone. The SEC's directive actually says that chief executives and financial officers must sign the affidavits when their companies file their next financial statement or report a significant event from that day on. Some CEOs won't have anything to file until weeks later.

In fact, since the new rules were announced on June 27, even honest executives haven't had time to find toxic

Smoke and Mirrors

Sectors where earnings may still be falsely inflated

CABLE TV, TELECOM, BROADCAST MEDIA

Use of EBITDA (earnings before interest, taxes, depreciation, and amortization) overstates profits by factoring out capital spending, taxes, and financing charges.

TECH, PHARMACEUTICALS, CONSTRUCTION, RETAIL

Overaggressive booking of sales before getting paid—especially under long-term contracts—inflates revenues. Murky accounting for manufacturers' incentive payments to retailers also hid costs.

TECH, FINANCIAL SERVICES

Heavy use of options, not deducted from earnings, understates

TELECOM, PHARMACEUTICALS

Booking operating expenses as capital investments lets companies

the costs from earnings over several years, boosting current profits.

ed with an historic average of 15. Wall Street strategists say all news is actually good for the market. Even erstwhile bears are leaning toward equities. "My feeling at the end of the year was bearish toward stocks and bullish toward bonds. With the stock market coming down, I'm lifted," says Byron Wien, U.S. investment strategist at Morgan Stanley. He expects the S&P to end the year in single digits—not bad, considering it's currently down 21%. He and others think the market is undervalued given the seemingly high price-earnings ratios. Why? Even if prices rise somewhat, cleaner accounting puts a premium on earnings, they'll still be profitable because the underlying earnings trend is up,

and interest rates are at 40-year lows.

The massive fund redemptions look good to some. "The sentiment tells you stockholding is becoming vilified by a whole class of investors. By definition, the bottom is when there's no one left to sell. At the top, there's no one left to buy," says McManus. So we could be in the midst of a buying opportunity. Thomas Galvin, chief investment officer at Credit Suisse First Boston, notes that 88% of New York Stock Exchange stocks are trading below their 10-week moving average—indicating that they are aggressively oversold. Historically, the best recent times to buy—September, 2001; August, 1998; August, 1990; and October, 1987—were when 80% or more of stocks traded below this mark.

Still, it could be months—even a

year or two—before the market stages a sustainable recovery. Once it does, there will be loads of cash waiting to drive it onward and upward. According to the Investment Company Institute, investors held more than \$2 trillion in money market accounts in the week ended July 10, vs. \$1.4 trillion at the peak of the bull market in 2000.

When the market finally does recover, investors can't expect anywhere near the gains realized in the late 1990s. UBS PaineWebber's Kerschner is calling for a "return to normalcy," in which annual gains of 7% or 8% will be more usual. And that will be just fine, thank you.

By Marcia Vickers, with Heather Timmons and Robert J. Rosenberg, in New York, and with Geoffrey Smith in Boston and David Welch in Detroit

companies over the past two years. But under current rules, most companies won't revise them before December.

As for options, analysts at S&P say they would reduce S&P 500 earnings by 17% this year if they were expensed. But that estimate is based on the values companies have put on op-

erate tracker First Call. "As much as we would like to think companies are bending over backwards to do the right thing, it is not happening."

Brokerage-house analysts aren't much help, either. They tend to do what companies want. For example, only 6 of the 21 analysts that have given First Call their estimates for AOL Time Warn-

WHAT DEADLINE? *Companies won't be able to give their books a thorough scrubbing until next spring*

tions grants in their annual reports. Accounting regulators say they know of no one who has checked the assumptions behind the calculations.

Sadly, for all the uproar, there's a sure sign that execs haven't fully bought into the clean-numbers movement:

the way in which they present their market-moving earnings press releases. Many tech companies still emphasize figures that make them look better than results that conform to generally accepted accounting principles, GAAP. They headline dressed-up numbers such as pro

forma earnings, which exclude any expense they choose. Media and cable-TV companies favor earnings before interest, taxes, depreciation, and amortization (EBITDA), another non-GAAP profit measure that glosses over capital spending. "There has been a little bit of progress [toward GAAP], but basically companies don't get it," says Chuck Hill, director of research at earnings es-

ter Inc.'s 2003 earnings actually provided GAAP figures. The rest just follow company guidance. The difference: 62¢ per share with GAAP vs. \$1.05 using AOL's custom-made measure of choice, cash earnings per share, which understates taxes.

Even true believers in the Aug. 14 effect admit they are making a leap of faith. "If we can get all this behind us by the end of August, then we could be set up to rally in September and through the end of the year," says Ed Yardeni, chief investment strategist at Prudential Securities Inc. Yet he concedes that there will remain "a lot of questions about the right way to account for earnings."

Realistically, the best investors can hope for is some relief from the nagging feeling that they have been suckered. They invested in companies only to realize they have no idea what those businesses are really earning. It will be a while before they believe they know enough.

By David Henry in New York, with Amy Borrus in Washington

treatment for pension plan assumptions. The delays will likely show up on earnings—and the stock price—in months. For example, the optimistic pension plan assumptions boosted earnings at many

COMMENTARY

By Michael J. Mandel

THE CASE FOR OPTIMISM

For more than two years, the stock market has been on a downward slide. Since the Standard & Poor's 500-stock index peaked in March, 2000, it has lost more than 40% of its value, with the drop seemingly accelerating. Another month like the last one will make this the deepest market plunge since the Great Depression.

It's only natural, then, that investors are scared that the rest of the year will bring more of the same. Their worries are fed by skepticism about corporate accounting and earnings, anger at executive greed, and doubts about the economic recovery's strength. Add in fears about more terrorist acts, and it seems as if there is no bottom in sight.

Despite these concerns, there's a good chance that both the stock market and the economy are poised to stage a stronger-than-expected recovery in the coming months. For one, corporate profits could be surprisingly robust. Slowing wage growth is finally enabling companies to boost their bottom line, although it may not be immediately evident amid the blizzard of earnings restatements and accounting changes.

And the tech sector may be on the verge of a rebound, the latest round of layoffs announced by Intel Corp. on July 16 notwithstanding. The excess capital spending of the 1990s appears largely to have been worked off, as Federal Reserve Chairman Alan Greenspan noted in his testimony to Congress that same day. Moreover, higher profits will make corporate buyers more willing to spend. Additionally, low interest rates mean that plenty of liquidity is available to fuel a market rally.

Of course, potential pitfalls lie ahead. The two biggest: more terrorist attacks and the discovery of major accounting fraud at another company outside of telecom or utilities. Either one could keep the market from recovering anytime soon.

But more grounds exist for optimism than angry investors realize. Remember that over the last 10 years, the U.S. stock market and economy have shown a great propensity for unexpected swings, both up and down. In 1996, for example, Americans were anxious

about the future, as companies kept laying off workers. A February, 1996, *BusinessWeek*/Harris poll showed that 86% of Americans were concerned by the possibility of a slowdown in economic growth, and 56% were worried about another stock market crash. Instead, what followed was one of the biggest booms in history. Similarly, as the country approached the peak of the stock market bubble in December 1999, most analysts were still optimistic about the market's prospects, expecting a gain of 10% in the S&P 500 in 2000, according to a *BusinessWeek* survey.

Here's why the economy and the markets may be ready to make yet another U-turn. Start with corporate profits. Peering beneath the accounting tricks, the underlying profit margins of most corporations really depend on two factors—worker productivity and wages. The ideal combination for corporate profits is high productivity growth plus slow wage growth.

That's exactly what we're heading for. Productivity seems

to be rising at a solid 2.5% to 3% with more data to come when Commerce Dept. releases second quarter growth figures on July 31. Meanwhile, wage growth is slowing sharply as companies cut back on pay. In the first half of 2001, average hourly earnings rose at a 3.8% rate. The latest figures show wage growth down to about 2% in the first half of 2002, and likely to fall further, as long as unemployment remains around 6%.

This slowdown in wage growth will have an enormous impact on profits, as payments to labor are about ei-

TECH COMEBACK

The equipment and software overhang of the '90s appears to have been worked off. So if profits continue to rise, managers will want to reopen the spending spigots



large as pretax earnings. As a one-percentage-point decrease in growth, all other things being equal, translates into an additional percentage points in earnings. The early second-quarter profit already are reflecting these companies such as Nextel Communications, Merrill Lynch, and Motorola announced results that met expectations.

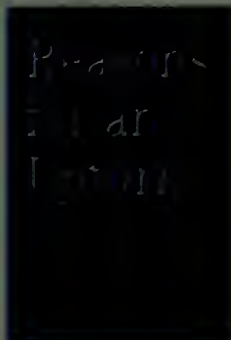
As the economy continues to rise, the tech sector will be one of the big winners. Since late 2000, business spending on computers, communications and software has been depressed, down by a combination of excess capacity in the boom years and low margins.

After two years of the worst downturn ever, corporations have slashed technology spending so much so they have reduced or even eliminated the overhang of equipment and inventory. According to calculations by

BusinessWeek, from 1995 to 2000, companies overspent on technology by about \$100 billion, as such outlays far outpaced the long-term growth trend of 12% a year. Since then, corporate tech spending has plummeted, dropping as much as 20% below what the long-term trend would imply.

This suggests that once corporate profitability begins to head up, information technology managers will want to open up the spending spigots. Indeed, if they underspent their budgets during the first half of 2002, they may have to accelerate outlays toward the end of the year, which would create a big pop.

Already there are signs of a tech revival. According to the latest data from the Federal Reserve, production in the technology sector rose by 6% from



► **Second-half profits** could be higher than expected as slowing wage growth boosts bottom lines

► **Tech spending** may rebound now that companies have worked off the excesses of the '90s

► **Continued low interest rates** will provide plenty of liquidity

March to June, compared with only a 1% gain in the rest of manufacturing. Capacity utilization, too, is on the rise among tech companies.

The job cuts at Intel do not necessarily signal bad news. For one, other technology companies, such as Motorola, are forecasting higher sales in the second half. Moreover, labor force reductions in the sector can often lag the worst of the downturn, as do job reductions in other parts of the economy. In 1996, as the greatest tech and telecom boom in history was gathering momentum, companies such as Texas Instruments, Apple Computer, Motorola, and IBM were still trying to reduce costs by laying off or buying out tens of thousands of workers.

The final force working in favor of a strong rebound is the Fed's low interest policy. The Fed funds rate, at 1.75% since December 2001, is well below inflation. That makes borrowing extraordinarily cheap and means a lot of money is ready to move into the stock market when and if share prices start to rise. Moreover, the low rates inoculate banks, Wall Street investment banks, insurance companies, and other financial institutions from the impact of the falling stock market. As long as these companies can raise money cheaply, they can keep lending and making money. That's a real plus for the economy.

While investor trust has clearly suffered from the steady stream of revelations of corporate malfeasance, it does not always dictate which direction the stock market goes. At the top of the market, investors are far too bullish. And at the bottom, they are far too bearish. The same thing could be happening this time.

Ultimately, the performance of the stock market and the economy will be determined by tangibles: Productivity, profits, interest rates, and the perceived usefulness of technology investments. That's where the good news could come.

Mandel is BusinessWeek's Chief Economist



COMMENTARY

By Rich Miller

THE WEAK BULLY PULPIT



When the stock market fell out of bed and the economy teetered last year, the Federal Reserve and Bush Administration knew exactly what to do. Fed Chairman Alan Greenspan slashed interest rates 11 times in the central bank's fastest rate-cutting spree ever. George W. Bush was no slouch, either. The President rammed through a \$1.3 trillion tax cut that included a quick \$30 billion rebate to aid struggling families.

All that, however, feels like a long time ago. The stock market is once again tumbling, and the recovery is at risk. But this time, the challenge is different and, in some ways, more daunting. On one level, the real economy is on the upswing, as evidenced by a healthy 0.8% rise in industrial output, reported on July 16 (page 29). Yet investor psychology has turned pessimistic, fed by accounting scams and fears that many companies' profits will have to be revised downward.

As a result, there is a growing sense that traditional stimulative measures may not work in the face of investor panic. Instead, what economic policymakers need to do is somehow convince investors through words and deeds that they are up to the task of tackling corporate crime. But as Bush's ham-handed attempts to manage the market in recent weeks clearly show, that's a lot easier said than done.

Much is at stake. The White House reckons that the 13% drop in the market since May could reduce economic growth by as much as 0.7 percentage points over the course of a year. And

some Bush Administration officials, most notably perennial economic bear and chief economic adviser Lawrence B. Lindsey, fret that further falls on Wall Street are in store. Swooning stocks hurt the economy by robbing consumers of spending power and making business investment more costly. Politically, they also pose dangers for Bush. While his overall approval ratings remain high, he has slipped behind Democrats in the polls on the issue of who is best able to clean up corporate corruption.

Small wonder, then, that it's nail-biting time at the White House and the Fed. Part of the unease has to do with the feeling that the tried and true solu-

“Confidence is a difficult thing to put your finger on. You don't reverse investor confidence overnight”

— FED CHAIRMAN ALAN GREENSPAN

tions to economic angst may not work this time. Greenspan signaled on July 16 that he was in no mood to cut rates again to bail out the stock market. With short-term rates already at a 40-year low of 1%, the Fed has to be careful to husband what monetary ammo it has left. What's more, a rate cut now might do more harm than good. It would pump up an inflated housing market some Bush officials fear is already a bubble. It might also dent the dollar, whose weakness is starting to worry the Fed.

Fiscal policy, too, seems to be in a lock. Some in the Administration would

drive to expense stock options and working with Congress on a tough counting bill.

Of course, restoring investors' faith in financial markets isn't going to happen quickly. “Confidence is a difficult thing to put your finger on,” Greenspan says. “You don't reverse investor... confidence overnight.” True enough. But recognizing the dimensions of the problem and responding with a convincing plan would be a good place to start.

Miller covers the economy from Washington, D.C.

no doubt like to accelerate the pace of income tax cuts now slated for 2003. But politically, that's not feasible. Democrats are already attacking Bush over the \$165 billion budget shortfall projected for this year. And there's a fear that overly aggressive fiscal action will spook the bond market by heightening concerns of big budget deficits.

So are policymakers powerless? From it. But they may have to think conventionally to convince investors that the markets finally are on the mend. Greenspan made a start on July 16 with a rare admission of error, the Fed chief acknowledged being mistaken in thinking that accountants could regulate themselves. And he strongly backed a Senate bill to reform their industry, the dismay of White House economists.

SELL? The Dow really hates those pep talks favor a milder House version. In another nod to Bush, Greenspan repeated his strong support for deducting stock options as an expense on corporate income taxes.

So far, Bush has been much less reassuring. In two speeches punctuated by market swoons, the President seems an unconvincing reformer. He can't be better. But he needs to clear the air of lingering doubts about his share dealings as a director of Harken Energy Corp. more than a decade ago. He must show he's willing to take on the Big Business donors who bankrolled his Presidential campaign. That means signing on to the





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INSURANCE, FINANCIAL SERVICES AND THE FREEDOM TO DARE.

TO EXPENSE OR NOT TO EXPENSE

In the debate over stock options, expensing is picking up steam

Just weeks ago, it looked like the truth-in-accounting brigade was losing the battle to force companies to deduct from earnings the value of stock options granted to executives and employees. Congress sidestepped the issue three times in five months. The Financial Accounting Standards Board (FASB), the group charged with setting accounting rules, didn't want to touch it, either. Even the board of the California Public Employees' Retirement System, the nation's largest public pension fund, shelved a staff recommendation calling on companies to expense options.

But the corporate scandals that have ignited public zeal for accounting reform are suddenly placing stock options in a harsh light. Many experts now conclude that stock option overload contributed to the accounting fiascos at companies such as Enron Corp. and WorldCom Inc. Eager to cash in their options, managers may have resorted to questionable accounting practices and hasty acquisitions to pump up earnings and revenues and boost share prices. Rather than align the interests of shareholders and management, options seem to have done the opposite: transferred vast amounts of wealth to executives,

even as outside shareholders have suffered. That's put those who oppose stock options expensing, like John Endean, president of the American Business Conference, a trade group of mid-size companies, on the defensive: "Stock options are now seen as the problem rather than the solution," he concedes.

Curbing the use of options by forcing companies to count them as an expense is the reform *du jour*. Bowing to investor demands for more transparent accounting, Coca-Cola Co. on July 14 said it would start expensing options as of this year's fourth quarter. Pushing hard for the change was board member Warren E. Buffett, CEO of Berkshire Hathaway Inc., Coke's largest shareholder. The Washington Post Co., where Buffett is also a director, and Bank One quickly followed Coke's lead. And a handful of other blue chips, including Ford, H.J. Heinz, and Gillette—another Buffett company—said they are considering

expensing options like they would for any other compensation cost. "It's a new environment today," says Coke Chief Financial Officer Gary P. Fayard.

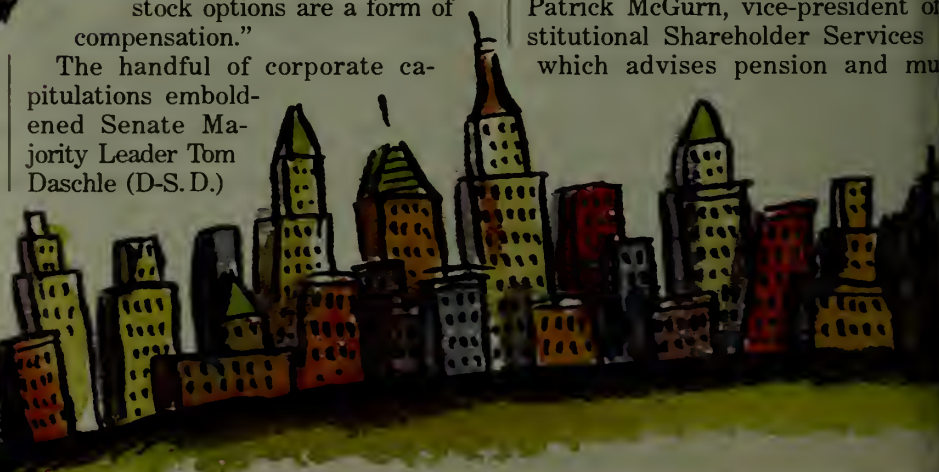
"There's no question that stock options are a form of compensation."

The handful of corporate capitulations emboldened Senate Majority Leader Tom Daschle (D-S.D.)

to promise a vote on a measure that would direct the FASB to decide in one year how options should be treated in financial statements.

Even if that fails, options' cost-of-status could be upended by ref across the Atlantic: On July 16, the International Accounting Standards Board (IASB) in London announced it would propose new rules by yearend to require all European Union companies to expense stock options within five years. If the IASB follows through, the board is likely to renew its long-mantled crusade for stock option expensing, say FASB sources. One reason: Congress is about to place the FASB, which lost a bitter battle over options expensing in 1994, on a more independent footing. Pending legislation would require all public companies to contribute to the FASB's funding, thus freeing it from pleading for funds from companies and accounting firms to which it then beholden.

Moreover, the FASB, under Chairman Robert H. Herz—who previously served on the IASB—is publicly committed to harmonizing U.S. and international accounting standards. If the IASB requires stock option expensing, the FASB "will have to act," says Patrick McGurn, vice-president of Institutional Shareholder Services, which advises pension and mu-





s. "Otherwise, the U.S. will be seen as using substandard accounting." No less than Federal Reserve Chair Alan Greenspan thinks the momentum for counting options as an expense is unstoppable. "It's going to happen, and quite appropriately so," Greenspan told the Senate Banking Committee on July 16.

Many companies insist the rush to expense options is misguided. The argument: Stock options do not require actual cash outlays, so should not be counted on the income statement as compensation costs, as are salary or bonuses. Companies warn that expensing options will depress earnings and cause further declines in share prices. If companies decide to curtail the use of options as a result of having to expense them, they will lose a valuable tool to recruit employees and motivate executives. "When management doesn't have skin in the game, they don't have any interest in what happens to share price," says Continental Air's CEO Gordon M. Bethune.

That's a debatable point, of course. What's more critical is to restore investor confidence—and expensing stock options will go a long way toward the goal, says Buffett. For years, Buffett has been one of

the leading voices, along with a handful of institutional investors, supporting expensing of options. Other companies that follow Coke's lead, says Buffett, will "develop a reputation for being believable, for not hyping things, and will be valued more than those whose CEO is flim-flamming [investors]."

No doubt, deducting the cost of stock options on the income statement will reduce earnings. On average, estimates Standard & Poor's, expensing options would have trimmed the S&P 500-stock index's 2001 earnings-per-share of \$24.69 by 24.5%, and it would cut this year's estimated EPS of \$35.47 by 17%. That means stocks will look more expensive.

For Silicon Valley, whose entrepreneurial culture is highly dependent on employee ownership, the cost of expensing stock options could be particularly steep. Cash-poor startups use the lure of options—with the possibility of big riches down the road—to attract top engineers and software writers. "Without options, it's going to be hard to recruit new talent," says Mark Heesen, president of the National Venture Capital Assn. What's more, morale and even productivity could decline. If forced to expense options, tech execs warn, they will no longer dole them out to everyone from the mail sorter to the chief programmer. "The options that are going to go

Why Critics Say Options Should Be Expensed

- Some 75% to 80% of executive pay now comes in the form of options. Since all other forms of compensation must be deducted from earnings, options should be treated the same.
- Deducting the cost of options will yield more accurate earnings numbers, which should help restore investor confidence.
- Since options are now all but free to companies, excessive grants to top execs have been encouraged. But options do have costs: They dilute shareholders' stakes and deprive companies of the funds they would otherwise get by selling those shares in the open market. Such costs should be reflected in earnings.

- Bringing more discipline to options grants will also reduce the incentives top execs now have to pump their stocks through short-term earnings maneuvers, in hopes of cashing in big options gains.

Why Defenders Disagree

- Unlike salaries or other perks, granting options requires no cash outlay from companies. Since there is no real cost to the company to deduct, doing so will unjustly penalize earnings.

- There are no universal standards for expensing options; all valuation methods require big assumptions and estimates. So expensing them will reduce the accuracy of income statements, and leave them open to manipulation.

- Deducting the cost of options will reduce earnings, which is likely to drive down share prices.

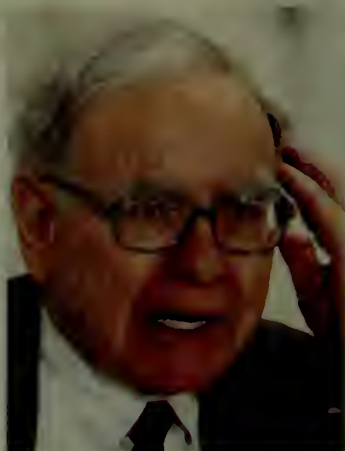
- Rather than take the hit to earnings, companies will issue far fewer options. That would hurt morale, limit a key tool used to lure talent, and inhibit companies from aligning employee and shareholder interests.

- Tech firms argue that generous option grants have spurred the risk-taking and entrepreneurship so crucial to innovation. Expensing options risks damaging that benefit.

away are those that go to rank-and-file employees," warns Alfred P. West, Jr., CEO of Oaks (Pa.) asset manager SEI Investments.

While CEOs like to note that more than 90% of those getting options are the foot soldiers in their companies, 80% of the value goes to the most senior executives. "It's true that a lot more people are getting stock options today, but most of the benefit is going to managers," says Corey Rosen, executive director of the National Center for Employee Ownership, an independent think tank.

Along with employee morale, the fed-



Companies that expense options will

“develop a reputation for being believable, for not hyping things, and will be valued more than those whose CEO is flim-flamming [investors]”

— WARREN BUFFETT, CEO OF BERKSHIRE HATHAWAY

eral budget deficit could take a hit. Mark Zandi, chief economist at consulting firm Economy.com, says that if the value of options offered and exercised shrinks by, say, 25%, individual income tax payments from stock options would drop

by about \$15 billion. This would be significant in light of the \$165 billion budget deficit, but modest in the context of \$2 trillion in tax revenues.

Still, such prominent critics of the existing treatment of options as Greenspan point out that it allows

PINNING DOWN THE VALUE OF A STOCK OPTION

As Congress and Corporate America ponder the pros and cons of expensing stock options, a difficult issue looms: Even if a company decides that expensing options is the right thing to do, as Coca-Cola Co. and Bank One Corp. have recently done, determining just how to value them is tough. After all, an option represents the right to buy shares for an unknown price at some indeterminate point in the future. So how much is that worth? This is the minefield that many companies—and their shareholders—could soon face:

Why is valuing options so tough?

The big problem is that corporations can't predict what will happen to share prices, who will leave the company before their options vest, and which options will expire underwater—that is, with no value. So they have no way of knowing what options will be worth when they're exercised many years after issue. Unlike shares, which have a market value at all times, the true value of options is only known when they're cashed in, in some cases long after the employees who received them provided their service to the company.

Still, most companies prefer to estimate the value of options on the day

they're granted—an imprecise method that CFOs have nonetheless become wedded to over the years for its ease of use and predictability. They've developed a number of methods for predicting that future value, none ideal. The choices are mind-numbingly complex and involve making big assumptions that can significantly impact future earnings.

What about the "Black-Scholes" method?

The well-known option-pricing formula, developed in 1973 at the University of Chicago by Fischer Black and Myron S. Scholes, uses option terms such as the strike price and life-span of the option, stock price, volatility, and dividend yield to estimate future value. Black-Scholes and its many variants have, over the years, become the most widely used methods of valuing employee options for disclosure in financial footnotes.

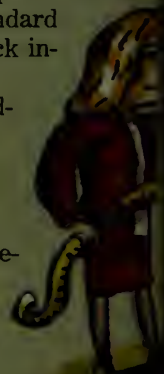
But they are far from perfect. Designed for valuing options traded in open stock exchanges, the standard Black-Scholes formula isn't adjusted to account for the added restrictions of employee options, such as vesting and lack of transferability. Those limits make employee options worth considerably less than exchange-traded options. So, in effect, companies that use the formula to

expense options would take a larger charge to earnings than is necessary. Bear, Stearns & Co. estimates using the Black-Scholes model expense options would have trimmed off the earnings per share of the Standard & Poor's 500-stock index last year; 13 companies, including Microsoft Corp. and Cisco Systems Inc., would each have had to deduct pre-tax options expenses in excess of \$1 billion in 2001 alone.

What does Coke plan to do?

Each October, Coke says, it asks two Wall Street firms to provide quotes on options to buy 10,000 shares of Coke stock and options to sell 10,000 shares. The average of the two quotes would be used to determine the value, and thus the charge to earnings.

By using an "objective third party," Coke hopes to avoid any accusations that it tweaked the numbers. Of course, the firms may choose to use Black-Scholes to value the options, but it will be up to them to determine the values of the variables, making it impossible to game the process. The binding quotes, meanwhile, provide a guarantee that the firms won't lowball the value of the options in an effort to reduce Coke's charge to earnings—and possibly



to reap a double bonus. Not only avoid expensing the costs of options, they also can deduct from taxes the difference between the issue price and the exercise price. Microsoft Corp., for example, showed a \$2 billion benefit from the tax deduction, while its value was \$2.2 billion higher by not expensing options, according to a report by Credit Suisse First Boston. Some companies can take a tax deduction on and still not expense options, as evidenced by the stock options willy-nilly. Expensing [options] has been an important source of the distortion of executive pay," says Kenneth Bertsch, director of corporate governance at the Teachers' Retirement Fund TIAA-CREF. Roughly three-fourths of executive compensation now comes in the form of options.

To many corporate governance experts, less-hyped earnings figures will boost confidence and bring back rattled investors. That's why companies like Coca-Cola are reacting by giving the market what it seems to be demanding: more transparency. If Coke had expensed options in 2001, earnings-per-share would have dropped by only 9¢, to \$1.51 from \$1.60. Because Coke is not a big issuer of options, it's relatively easy for the soft-drink company to look bold and make the switch. Indeed, stock option grants represent only about 1.8% of Coke's 2.5 billion shares outstanding.

Other consumer goods, manufacturing, and retail companies, hoping for a reward from investors, may follow Coke's lead. "It gives the company a good image in the investment community," says Tim Drake, senior equity

analyst for Banc One Investment Management, which owns 8.4 million Coke shares. Coke's share price rose 95¢, to close at \$52, on July 15, after its announcement. "Companies that convince their investors that they're committed to clear, candid, and conservative accounting are going to win the race for capital," says Nell Minow, a corporate governance activist.

Until recently, that race was won by the companies that boosted earnings at any cost, even if it meant exaggerating revenues, hiding losses, and fraudulently listing everyday expenses as capital expenditures. The new winners will be the companies that play by the rules.

By Amy Borrus and Paula Dwyer in Washington, with Dean Foust in Atlanta, Louis Lavelle in New York, and bureau reports

the only way of accurately stating the true cost of options to the company.

Unfortunately, simply waiting also violates most of the accounting principles about expense recognition that auditors hold dear. Companies are required to deduct expenses during the period in which they are incurred—that's why equipment is amortized over its useful life instead of being expensed when it's purchased or sold. Expensing options only when they are exercised violates that basic principle, sometimes requiring companies to deduct the option expense long after

the employee's period of service. An executive who retires with a boatload of vested options would, in this scenario, create a huge expense when he exercises them—one that should properly have been taken throughout the period when he was employed.

Are there any other methods that avoid these problems?

To achieve much the same result of expensing at the time of exercising, some recommend a method known as intrinsic value. A company expenses the difference between the exercise price and the stock price throughout the vesting life of the option, repeatedly updating it as the stock moves. As the stock price rises, options become more valuable,

and that additional value is charged to earnings. If the stock declines, options decrease in value, and the charge to earnings evaporates. Companies that employ this method get a whole host of benefits. Unlike Black-Scholes, the simplicity of intrinsic value makes it tough to manipulate. Moreover, since the charge to earnings is considerably lower than any of the Black-Scholes variants, it's less disruptive to earnings—and the stock price. In a declining market, it's also the only accounting method that doesn't create a charge for underwater options.

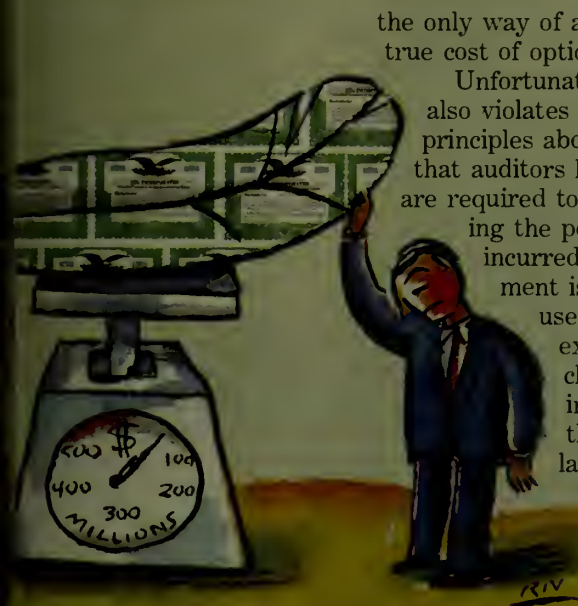
So what's the best?

Intrinsic value isn't perfect, but it's far less imperfect than the alternatives. It may be the best hope yet for solving the options dilemma.

By Louis Lavelle in New York

BusinessWeek online

For more detail on the options expensing debate, log on to www.businessweek.com.



ess. If the firms gave Coke a low price, Coke could simply book the 10,000 options from them as a one-time gain to profits.

wait until the options are

g until employees exercise them, then booking the difference between the exercise price and the stock price as an expense, companies would equal the amount they would spend to buy those options on the open market, or the company is forgoing by not exercising shares and pocketing the difference. And options that never get exercised never get expensed. This is

COMMENTARY

By Robert D. Hof

THIS REFORM WON'T KILL SILICON VALLEY

For more than a decade, technology companies in Silicon Valley and elsewhere have trumpeted employee stock options as the prime driver for innovation, entrepreneurship, and wealth creation. With good reason: Options, which promise executives and employees a stake in the company's success and thus an incentive to work smarter and harder, have fostered a culture that turns new ideas into highly productive, fast-growing companies. And it gives cubicle dwellers in companies from Microsoft Corp. to Cisco Systems Inc. a chance to get rich. All that made the tech industry a model for the rest of the economy.

No wonder tech execs don't want anybody messing with that magic recipe. Now, as shareholder and accounting groups clamor to expense options, tech companies warn that such a move risks killing the goose that laid the golden egg. Tech execs argue this measure would force them to cut option grants, especially to their rank and file. "Innovation differentiates us, and a lot of that turns on compensation incentives such as options," says Larry W. Sonsini, chairman of the influential Valley law firm Wilson, Sonsini, Goodrich & Rosati. "We shouldn't lose this tool."

Options clearly have their place, especially at startups that can't afford big cash outlays for talent. But it's time for Silicon Valley to come clean. If tech companies logged the value of their options as expenses last year, reckons Merrill Lynch & Co., their net income on average would have been a startling 67% less than reported. That should be reason alone for tech companies to rethink their excessive use of stock options.

Fact is, expensing options won't do

nearly the damage, from lower stock prices to reduced innovation, that Valley doomsayers contend. For one thing, the accounting shift wouldn't change a company's cash outlays. "If stock prices do go down, then that's an indication that there is a problem," says Merrill Lynch tech analyst Steven Milunovich. But he thinks analysts and most investors will realize that compa-



“Innovation differentiates us, and a lot of that turns on compensation incentives such as options”

**— LARRY SONSINI,
Wilson, Sonsini**

“Stock options are an incredible mechanism to get employees, management, and shareholders all aligned”

**— SCOTT McNEALY,
Sun Microsystems**



nies' situations haven't changed and will track earnings both with and without options, as they have with other noncash expenses such as goodwill.

Even some startups think expensing options won't affect behavior much. Executives at telecom startup TellMe Networks Inc., for instance, say they would simply take a large noncash charge and keep using options. "Most investors will look past this expense," says TellMe President Mike McCue. "To be competitive,

everyone has to give stock options. That won't change."

There's even less of a case to be made for large companies to use options as free money. Is there any justification for Microsoft to get a \$2.3 billion after-tax boost or Citicorp a \$1.7 billion free ride when they have billions of real dollars in the bank? Execs say options match a company's constituents. "Stock options are an incredible mechanism to get employees, management, and shareholders all aligned," says Scott McNealy, chairman and CEO of Sun Microsystems Inc. But studies by Oyer, an associate professor of Economics at Stanford University, show for companies with over 100 employees, options provide no real incentive to anyone besides top execs because

employees believe that stock price efforts can't have much influence on share prices.

Granted, expensing options could result in unintended consequences. Rick White, president of the tech industry lobbying group TechNet, says, "You're making it much easier to manipulate earnings than you have to try to estimate the value of options." But expensing them means that startups won't turn a profit for several more years, and some venture capitalists may stay away.

The real travesty, though, would be if tech execs make good on the warning that they must include the rank and file in the options game if expensing them becomes the norm. But that doesn't seem to be happening. Instead, execs should take the high road and cooperate with accounting experts on developing a workable method of expensing options. More important, corporate directors could scale back

from issuing gobs of options to executives, since the massive dilution often results is the main beef on the side of shareholders.

Silicon Valley was a hotbed of entrepreneurship and innovation long before stock options became a fixture of tech compensation. Calling stock options what they really are—an expense—won't change that.

Hof is BusinessWeek's Silicon Valley bureau chief.

ad·van·tage / *noun* 2: a
favorable position due to a
positive choice of action.



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The 2002 Honda Clearance. It won't last forever (the best things never do).
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COMMENTARY

By John A. Byrne

NO EXCUSES FOR ENRON'S BOARD

On Feb. 7, 1999, the audit committee of Enron Corp.'s board of directors gathered in London to hear some rather startling news. The company's auditors described Enron's accounting practices as "high-risk." David B. Duncan, who headed up the Arthur Andersen LLP team at the company, informed the committee that Enron's accounting was "pushing limits" and was "at the edge" of acceptable practice.

None of the directors, including Robert K. Jaedicke, a one-time Stanford University accounting professor who had been chairman of the audit committee for more than 10 years, objected to the procedures described by the auditors, requested a second opinion, or demanded a more prudent approach, according to the Senate Permanent Subcommittee on Investigations after a six-month probe of the Enron board's oversight duties.

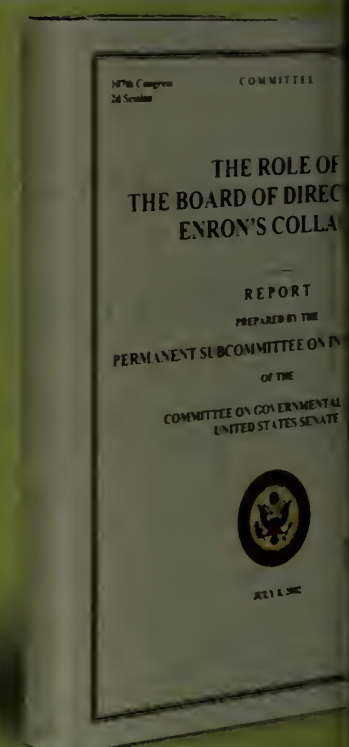
In fact, the subcommittee found that similar briefings by Andersen officials occurred once or twice each year from 1999 through 2001 with the same result: The auditors told board members that Enron was following high-risk accounting and no one drilled deep enough to learn the details or object. And despite his long tenure as chairman of the audit committee, Jaedicke rarely if ever had any contact with Andersen outside of official committee or board meetings, as governance experts recommend.

Even worse, Enron's board members knew

about and could have prevented many of the risky accounting practices, conflicts of interest, and hiding of debt that led to the company's implosion simply by asking some obvious questions. That at least is the conclusion of the Senate investigators. The panel's report shows no evidence of self-dealing, corruption, or fraud by Enron's directors, who still maintain that they cannot be held accountable for misconduct that was concealed from them. But after looking over thousands of pages of board documents and minutes and interviewing 13 of Enron's outside directors, the Senate panel found a nearly unprecedented breakdown in governance. W. Neil Eggleston, an at-

torney who is representing Enron's outside directors, called the report's conclusions unfair. "This board continually lied to and misled management," he said. "The amount of further investigation or questioning would have been enough to cause managers to tell them about the transactions."

Given the subcommittee's findings, laid out in a mind-numbing detail, however, the Enron defense on Capitol Hill becomes even more plausible. And it's another issue with troubling clarity: There is, in fact, almost no room for excuses for company directors who fail on the job. Instead of skimming with liability insurance paid for by shareholders, directors who fail must face at least a minimum level of oversight. They must be forced to pay the damages, just as executives should. Shareholders have a right to sue directors, who at the time were paid as much as \$350,000 a year in stock options, and



What the Subcommittee Found

■ As early as 1999, Arthur Andersen told the board's audit committee, headed by Richard Jaedicke, that Enron was a "maximum-risk" client, was "pushing the limits," and was "at the edge" of acceptable accounting practices. The board never asked Andersen to adopt a more prudent approach.

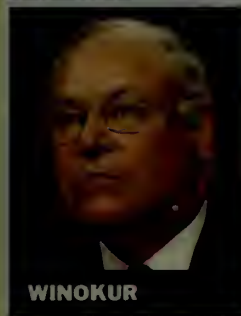
■ In 2000, the compensation committee, chaired by Charles LeMaistre, approved \$750 million in cash bonuses to Enron executives in a year when the company reported net income of \$975 million. Apparently, no one on the committee added up the numbers.

■ The compensation committee approved a credit line of \$7.5 million for CEO Lay and allowed him to repay loans with stock. Records show Lay cashed out \$77 million in one 12-month period.

■ When directors first caught wind of whistleblower Sherron Watkins' memo, not a single director asked for her name or for a copy. Among other things, Watkins expressed concern over private partnerships subject to review by the finance committee chaired by Herbert Winokur.



LEMAISTRE



WINOKUR



JAEDICKE

FINANCIAL REPORT

A Senate probe found that the directors knew they could have prevented many of the risky deals that led to Enron's implosion.

Enron's multi-billion dollar, off-the-books activity was disclosed to the Enron Board and received Board approval as a explicit strategy to improve Enron's financial statements. In fact, Enron's massive off-the-books activity could not have taken place without Board action to establish special purpose entities, issue preferred Enron shares, and pledge Enron stock as the collateral needed for the deals to go forward. In the end, the

Enron's Directors protest that they cannot be held accountable for misconduct that was concealed from them. But much that was wrong with Enron was known to the Board, from high risk accounting practices and inappropriate conflict of interest transactions, to extensive undisclosed off-the-books activity and excessive executive compensation.

Enron needed. By failing to provide sufficient oversight and restraint to stop management excesses, the Enron Board contributed to the company's collapse and bears a share of the responsibility for it.

tom stock, to be engaged and active. They were assured that directors will protect their interests above those of shareholders. And certainly, shareholders should expect that the board will step in when outside experts appear to warn of potentially dangerous warnings and heaped riches on Enron's directors. Yet Enron's repeated warnings by the "high-risk" account-Senate subcommittee made remarkably damning conclusions:

Over several meetings, the compensation committee approved \$750 million in cash bonuses to executives in a year when the oil-based company reported net income of \$975 million. In other words, the directors handed over an amount more than three-quarters of the profits to salaried managers—expense of the shareholders. Notably, no one on the compensation committee had ever added up the

compensation committee also approved a credit line for Chief Executive Kenneth L. Lay that eventually reached \$7.5 million, and then allowed him to repay it with stock instead of cash. He proceeded to use the credit line in express lane for dumping Enron stock. He repeatedly drew down

the line, sometimes daily, always repaying right away with stock. Doing so allowed him to delay reporting some stock sales for more than a year. The chairman of the compensation committee, Charles A. LeMaistre, told the Senate investigators that he did not think it was the committee's responsibility to monitor Lay's use of this credit line. If the directors had bothered to look, they would have discovered that as Enron's position became more precarious in the 12 months preceding revelations of its infamous off-balance-sheet partnerships, Lay extracted \$77 million in cash from the corporation that he replaced with Enron shares.

■ When the board first heard about a letter from whistleblower Sherron S. Watkins during a presentation by Enron's outside lawyers, the letter writer was not disclosed nor was her letter shown to directors. Shockingly, not a single director asked for her name or for a copy of the letter. The board was unaware of her most damaging charges, the subcommittee found.

Again and again, the red flags went up. Again and again, they were ignored. "They should have inquired further," says Charles M. Elson, director of the Center for Corporate Governance at the University of Delaware. "They were unwilling to ask and pursue tough questions."

For years, a simple standard known as the "duty of care" has guided the

behavior of corporate board members. That standard requires that a director discharge his duties in good faith, with the care of an ordinarily prudent person, and in a manner which he or she reasonably believes to be in the best interests of the corporation. By rewarding executives with

outsized pay packages and by failing to heed signs of danger, Enron directors failed that standard miserably. The board failed to ask probing questions. Its members neglected to follow up on critical issues that only they could monitor. It malfunctioned in

its role as the watchdog that shareholders rely on. As the subcommittee concluded, "By failing to provide sufficient oversight and restraint to top management excess, the Enron board contributed to the company's collapse and bears a share of the responsibility for it."

Trouble is, even when directors fail, liability is largely a myth. Board members are almost always indemnified by insurance paid for by shareholders. Many boards have also passed bylaw amendments to corporate charters limiting their liability. And many states have passed legislation to limit director exposure, even for negligent acts. Rarely does a director have to pay a price for failing to perform his job.

As the facts tumble out of the Enron boardroom, it has become increasingly clear that the directors were not merely misinformed by management or even sloppy in their oversight responsibilities. They were recklessly negligent and should be held at least partly accountable and personally liable for the company's meltdown. Sure, they're already embroiled in litigation, both with their insurance provider and with shareholders, and their reputations have taken a hit. But compared to what the investors they were charged with protecting suffered, it hardly seems enough.

Byrne covers management and governance issues from New York.

In Business This Week

EDITED BY ROBIN AJELLO

THE SEC CRACKS THE WHIP

THE SEC IS GETTING TOUGHER. On July 17, it fined Price-waterhouseCoopers \$5 million after finding the accounting firm had consulted with 14 audit clients on a contingency fee basis, a clear no-no. Moreover, the SEC found that PWC had improperly accounted for its own consulting fees at Pinnacle Holdings and Avon Products. The outcome of the probe provided a lift to the SEC's ongoing campaign to rein in accounting firms that provide consulting services to companies they audit.

In another show of resolve, the SEC was on the verge of a deal with Raytheon to settle charges that the defense contractor disclosed information to Wall Street analysts but kept regular investors out of the loop. It would be the SEC's first enforcement action for a violation of Reg FD—the fair disclosure rule aimed at preventing large

shareholders and analysts from getting special treatment over small investors.

SO MUCH PLASTIC, SO MUCH RISK

GROWTH IS GOOD? NOT IN today's climate. Bank regulators are scrutinizing the rapid growth of credit-card issuer Capital One Financial and calling on the firm to set aside at least \$247 million against possible loan losses. Capital One also agreed to put more customers in the higher-risk "subprime" category. The news lopped 40% off Cap One's share price on July 17 and dragged down such rivals as Provident Financial and MBNA, as fears spread that regulators would turn their gaze on the rest of the industry. Capital One CEO Richard D. Fairbank remained bullish, vowing profits will rise 30% for the year.

INTEL KEEPS CHIPPING AWAY

WITH HIGH-END CHIP SALES stuck in neutral, Intel announced 4,000 more job cuts on July 16. They will come mostly through attrition and voluntary retirement packages. The Santa Clara (Calif.) company also trimmed 2002 capital-spending and R&D budgets amid expectations of flat profits. The belt-tightening will help, but Intel needs corporations to replace their old PCs—and soon. Forays into consumer electronics and Web hosting have also gone bust. If sales don't pick up, longtime investors may decide that their faith in Intel's prospects is misplaced.

TYCO AND GOLDMAN: STILL FEUDING?

RELATIONS BETWEEN TYCO International and Goldman Sachs have been rocky ever

HEADLINER: DAVID DORMAN

OPPORTUNITY RINGS AT AT&T

Orderly transitions in the scandal-plagued telecom industry are still possible, it turns out. After several rocky weeks at WorldCom and Qwest, both of which pushed out their embattled CEOs, a new leader has been calmly appointed at AT&T.

The telecommunications giant announced July 17 that President David Dorman will become the next chairman and chief executive. He will succeed Chairman and CEO C. Michael Armstrong, 64, who is scheduled to step down when AT&T completes the sale of its cable-TV unit to Comcast by yearend, pending regulatory approv-

al. Armstrong will become chairman of AT&T Com-

Dorman, 48, is moving up to the job at

ical juncture. The industry is still

fering from a network cap-

put in place

ing the boom years of the

1990s, and prices are weak. But troubles at World-

and Qwest create an opportunity for AT&T to boost

market share. Now it's to Dorman, who previously

ran Pacific Bell, Internet startup PointCast, and

now-defunct AT&T-British Telecom joint venture

cert, to seize the moment.

By Steve Rosenbush
New York



CLOSING BELL

IN THE WRINGER

Maytag shares plunged 17% on July 16, to \$32.32 apiece, after the appliance maker said a sales slowdown will force it to idle factories to work off excess inventories. The entire industry has been hit as consumers, spooked by market gyrations, park their wallets.



since Tyco announced a breakup plan earlier this year—a strategy that left investors cold and was eventually reversed. Goldman was Tyco's financial adviser at the time. Now, it seems, the bad blood is worse than ever. On July 16, Goldman analyst Jack Kelly declared Tyco "not rated," citing "heightened concerns" over an SEC probe into the company's bookkeeping. Tyco says the investigation doesn't involve any new issues besides the ones it disclosed in June. Goldman says its research is objective. One thing seems sure: These two companies will not be working together anytime soon.

BIG BROWN'S BIG DEAL WITH WORKERS

THOSE BROWN TRUCKS WILL keep on rolling. Just 16 days before their contract was set to expire, United Parcel Service and the Teamsters an-

nounced on July 15 a "five" six-year labor pact. The hands part-timers a hour raise, gives full workers a \$5-an-hour and creates 20,000 new jobs. Given economic tions, it's a surprisingly erous settlement. The says the deal will cost billion over the life of contract. UPS clearly wa deal because the cor was starting to lose bu amid growing talk of a

ET CETERA...

- Intel, IBM, and three coms may build wireless hot spots around the
- Apple plans to start ing a Windows version iPod MP3 player in Aug
- Ford Motor moved in black in the second qu mostly by rebuilding inve
- A grand jury is pr United Way's Washington chapter for its use of don



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Everything else is just a p

BY RICHARD S. DUNHAM

DRUG PRICES! JUST WHEN THE GOP THOUGHT IT WAS SAFE...

month, when the Republican House approved a \$350 billion drug benefit for seniors, GOP strategists thought they had inoculated themselves against a key Democratic campaign issue: health care. And with Senate Democrats willing to agree among themselves on an alternative drug plan, Republicans had reason to feel good.

It was then. As the Senate kicked off a health debate on July 7, Democrats came up with a new strategy that caught the GOP off balance and sent a chill through the drug industry.

The plan: shift the focus beyond Medicare and push measures that promise to slash prescription costs for all consumers, not just seniors. "If we just attempt to slash Medicare without dealing with the issue of prices, we will simply break the bank," says Senator Debbie Stabenow (D-Mich.). "We have to deal with both."

As corporate scandals unnerve the public and embolden Democrats, Republicans must deal with both, too. A number of Republican senators, especially those running for reelection this fall, may embrace some of the cost-cutting drug bills. They are all searching for something they can hold up and say, "We did X," says a pharmaceutical industry lobbyist.

Senate Democrats, joined by some Republicans, are trotting out three proposals to win over voters angry at high drug prices. A plan by Byron Dorgan (D-N.D.) and Stabenow would let Americans import drugs from Canada, where retail prices are usually lower. Sen. Charles Schumer (D-N.Y.) and John McCain (R-Ariz.) would make it easier for generic drugmakers to bring their products to market. And a Stabenow plan would give states greater authority to negotiate directly with manufacturers over drug prices for Medicaid recipients and state employees. Lawmakers like the proposals because they could

slash the feds' own drug costs—in sharp contrast to a Medicare bill, which will add hundreds of billions to the deficit.

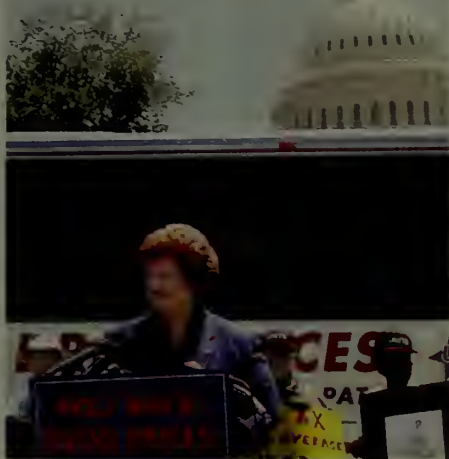
With the Medicare debate bogged down in partisan wrangling over costs and whether the plans should be administered by private insurers or Uncle Sam, Democrats think they have fresh ammunition for Election 2002. Their new claim: While the GOP may back a new drug benefit for seniors, only Democrats favor lower costs for everyone. Democrats are test-marketing the theme in Maine, where Senate candidate Chellie

Pingree has chipped away at GOP incumbent Susan Collins' lead by hammering at soaring prescription prices.

While there's growing support on Capitol Hill for the generic-drug bill and the Canadian import legislation, the powerful brand-name drug industry is fiercely lobbying against both. Drug-company reps say the generics bill, which would limit Big Pharma's ability to block low-cost rivals, will hurt profits and innovation. And the industry insists the import bill will expose Americans to unsafe drugs, such as gray-market knockoffs. Nonetheless, it's on the defensive. One reason: Some big employers, including General Motors and Verizon, back the generics bill. Says one beleaguered lobbyist: "It doesn't look pretty. There's a hell of a lot of pressure here."

Capitol Hill handicappers say the Canadian import bill is the most likely to become law this year. That may be little more than a Band-Aid for cost-conscious consumers. But it will allow lawmakers to say they did something, especially if a Medicare drug bill stalls. Dems could win either way: They can claim they've helped consumers or they can campaign against the GOP for thwarting more sweeping change.

By Howard Gleckman, with John Carey and Lorraine Woellert



STABENOW: Canada, ho!

CAPITAL WRAPUP

FED: THE MARKET HITS HOME

Stewards of the economy, Federal Reserve officials shy away from active buying and selling stocks. But they're not immune to bear markets. In most monetary mandarins saw their personal wealth shrink last year, according to an analysis by the nonprofit Financial Markets Center.

Fed officials don't disclose precisely how much they're worth—and in some cases, they don't release the value of their assets at all—it's hard to know exactly how much money they lost last year.

Yet even if the central bankers' wealth is near the low end of the ranges provided, the officials still lost out. For example, Fed Chairman Alan Greenspan and his wife, NBC News correspondent Andrea Mitchell, saw their combined holdings of between \$4.1 million and \$8.7 million shrink by as little as 2.7% or as much as 28% in 2001. While Greenspan confines his holdings to savings accounts, money-market funds, and Treasury bills, Mitchell holds some stocks.

Two other Fed officials also got hurt in 2001. Fed Vice-Chairman Roger Ferguson saw his family's assets shrivel by

3% to 4.2%. And Fed Governor Edward Gramlich's family holdings fell 3.2% to 4.8%. It's not known how much Governors Susan Bies and Mark Olson lost: They just joined the Fed and did not have to file last year.

While most Fed officials are worth well over \$1 million, losing money in the markets brings "extremely relevant personal experiences to bear on an otherwise abstract policy question" of whether the Fed should target stock prices, the analysis concludes. In other words, they feel your pain.

By Laura Cohn

SWITZERLAND

TROUBLE IN PARADISE



A series of catastrophes has the Swiss wondering where things went awry

What's the matter with Switzerland? That's the question *Blick*, a mass circulation tabloid, has been asking the country's business leaders in recent days.

Like most of its readers, the gaudy Zurich newspaper is reacting to the corporate, political, and managerial disasters that have shattered the complacency of Europe's most prosperous nation. The grounding of Swissair last fall, corporate-governance battles at

Zurich Financial Services Group and Credit Suisse Group this spring, the July 11 arrest of the ambassador to Luxembourg on charges of money-laundering, and, most tragically, the air-traffic failures that contributed to the July 1 Überlingen crash in which 52 Russian children and 19 adults died, have forced the Swiss to acknowledge that their landlocked country of just over 7 million people is no longer the bastion of order and efficiency it once was. "Swissair and [those other calamities] have trig-

gered a massive debate," says Schips, the head of the Swiss Institute for Business Cycle Research. "I were astonished that such things happen here." Now, the soul-searching has started, and with it a serious task to change the system.

First, though, comes the task of figuring out why things went awry. The Swiss are coming to grips with the fact that many business executives, politicians, and investors had wrongly convinced themselves that their way of doing things was superior. It's easy to see why. Switzerland is Europe's most successful economy, with gross domestic product of more than \$31,000 per person and an unemployment rate of just 2.1%. It has a massive balance-of-payments sur-

"No one exerted discipline on management. No one asked uncomfortable questions"

equal to almost 10% of GDP. Switzerland has five companies in the world's top 100—food processor Nestlé, financial-services giants UBS and Credit Suisse Group, and pharmaceutical companies Novartis and Roche Holding—compared with just six from Germany, which has a population 10 times as big.

Yet that success encouraged management at Swissair, Zurich Financial Services, and Credit Suisse to embark on ill-considered expansion programs and to press ahead with them even when it became clear that they weren't in shareholders' interests. And it bred the complacency that allowed air-traffic control to run a third-rate operation. The malaise cuts across public and private sectors. "No one exerted discipline on management. No one asked uncomfortable questions," says Hans Geiger, head of the University of Zurich's Swiss Banking Institute and a former Credit Suisse executive board member.

The boards of most Swiss companies are often little more than rubber stamps, made up of members of the country's small, conservative, smug Establishment. Everyone knows everyone else and sits on each other's boards. So Nestlé CEO Peter Brabeck-Letmathe is vice-chairman of Credit Suisse's board, while Credit Suisse honorary Chairman Rainer E. Gut is chairman of Nestlé. If these players and members of the same political or Zurich guild, they often know each other from army days: Many captains of industry were also officers.

Meanwhile, Switzerland's passion for democracy doesn't extend to the corporate sphere. Institutional investors have been far too passive. For example, they didn't challenge former Zurich Financial Chairman and CEO Rolf Hüppi after his rapid expansion program ran into difficulties and the company's share price plummeted. "This is a country where most political decisions are made by the people through referendum," says Geiger. "Yet big shareholders have never made any effort to exercise control over the companies they own."

The string of recent catastrophes has unnerved ordinary Swiss. "I always thought we had the world's best system, but now, I see I was mistaken," says Anne-Marie Mudry, a retired banker from Bern, the federal capital. The anti-Establishment Swiss People's Party is exploiting that dismay. It's now the country's most popular political grouping, with more than 20% of the vote, according to pollsters. "The political class and some people in Big Business are as inefficient as they are self-important," says the party's best campaigner, Christoph Blocher, a poor pastor's son who built up a huge chemicals empire before turning to politics.

Voters are in vengeful mood, increasingly distrustful of big companies and free markets. Last month, the people of Thurgau, a canton northeast of Zurich, threw out plans to turn the cantonal bank, currently a public institution, into a joint stock company. The cantonal government can't even think of privatizing the bank. And in September, voters look set to veto plans to open the electricity market to competition. Individual investors are restive, too. Thousands supported activist Hans-Jacob Heitz's bid to oust Credit Suisse Chairman and CEO Lukas Mühle- mann at the annual meeting on May 31. "Public and shareholders' trust in large companies has begun to erode dangerously," Justice Minister Ruth Metzler-Arnold told business leaders in a speech last month. "Further erosion in that trust would undermine our economy."

Shocked out of their complacency, the leading lights of Swiss industry have hammered out a new corporate-governance code. Companies will be required to publish the salary of their highest-paid executive and disclose the total amount of money and perks given to board members. "This is the first time Switzerland has had

this sort of regulation," says Dominique Biedermann, the director of Foundation Ethos, a shareholder group that represents pension funds.

Meanwhile, overconfident managers are increasingly being brought to heel. At Credit Suisse, Mühle- mann is being forced to give up the chairmanship after next year's annual meeting. Hüppi has stepped down after major shareholders at Zurich Financial finally turned against him. And politicians are no longer as keen to sit on company boards, fearing they may be caught up in a corporate disaster. That will put some much-needed distance between politics and business. "Switzerland is becoming a normal country," says Rudolf Ramsauer, chairman of Economiesuisse, the Swiss Business Federation.

Plenty more needs to be done, though. Despite Switzerland's wealth, its economic growth is flat. One way to boost productivity is to open the protected areas of the Swiss economy—including agriculture, construction, and tourism—to foreign competition, though that would be hard to sell to voters at this point.

Up to now, the Swiss model has proved remarkably resilient. The watch industry successfully restructured after being almost crushed by Japanese competition in the 1970s. And other manufacturing sectors did likewise in the 1990s when their competitiveness was eroded by the soaring Swiss franc. But can the country as a whole renew itself? "Whether Switzerland becomes Europe's cow patty or its jewel is still an open question," says David Bosshart, director of Gottlieb Duttweiler Institut in Zurich, which analyzes the retail sector. Well, before change comes the jolt. The Swiss have definitely been jolted.

*By David Fairlamb
in Zurich*

THE GOOD AND THE BAD

WHAT HAS GONE WRONG

- Corporate-governance problems have surfaced at many large companies
- Too many politicians sit on company boards
- Little economic growth for much of the past decade
- Productivity in many sectors of the economy is no longer on the rise
- Assault on bank secrecy could hurt the banking sector

WHAT'S STILL RIGHT

- Lowest corporate taxes in Europe
- Stable political system
- Highly flexible labor market
- World-beating infrastructure
- Lowest level of tax evasion in Europe

Data: BusinessWeek

FRANCE

A TALK WITH 'THE GODFATHER'

Claude Bébéar on what
French business needs now

Claude Bébéar, the 66-year-old founder and chairman of French insurance giant Axa, is the most influential financier in the country—so much so that the French press calls him the "godfather of French capitalism." His key role in the recent palace coup against Vivendi Universal CEO Jean-Marie Messier is a reminder of just how powerful Bébéar remains. That power could now increase: Bébéar clearly has the ear of France's new center-right government. And he has set up the Institut Montaigne, an informal group of top executives and academics who are developing free-market solutions for France's problems. In mid-July, BusinessWeek's John Rossant and Carol Matlack dropped by Bébéar's luxurious Paris office near the Presidential Palace for a chat.

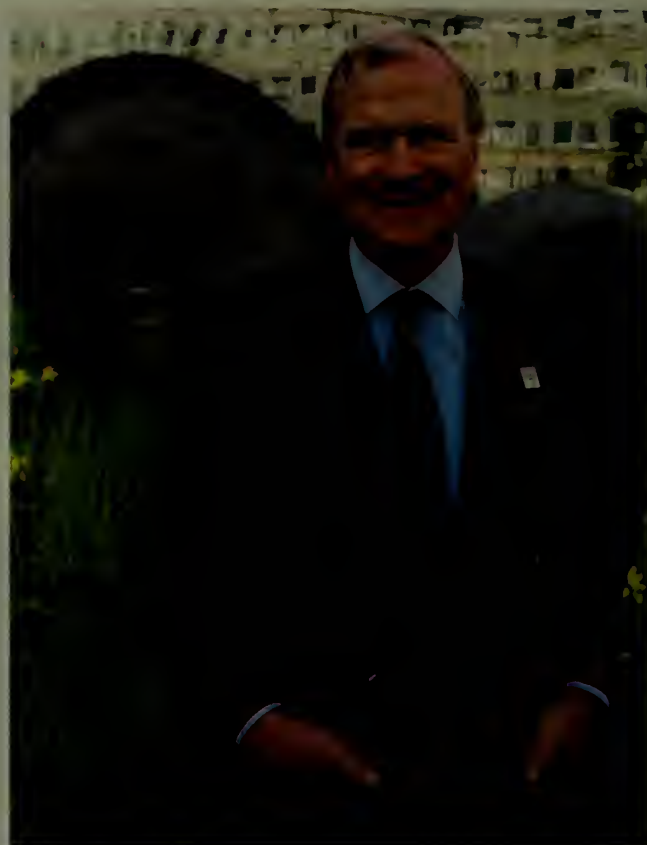
How concerned are you about the current turmoil in the financial markets?

It's very worrying. It's totally irrational. The American economy and the European economies are generally doing well. Yet there is a total loss of confidence in the financial markets. There is no justification for this extraordinary crash.

We need an intervention by the central banks. They must decisively show their confidence in the economy. And we need concerted action to limit the capacity of hedge funds to borrow. They create a volatility that's irrational—even immoral.

Isn't poor corporate governance to blame, too?

Incontestably, the companies that are in trouble generally are those where the board has not done its job. The board is there to define the strategy, to name top management, and to verify the execution of the strategy—and, if the strategy is not executed, to replace the management. Too often, boards' audit committees review the accounts with



auditors who are part of the corporate hierarchy. We need to have independent auditors, hired not by the hierarchy but by the audit committee.

What should be done to improve corporate governance?

I distrust government regulation. It always backfires. There are other, more efficient and flexible means. For example, ratings agencies can evaluate corporate governance. In fact, they're already starting to do this.

Why did you get involved in the Vivendi Universal controversy?

I didn't choose to get involved. It started when I had a private conversation with three people about the strategy of Vivendi and the personal strategy of Messier. It was leaked to *Le Monde*, [which] presented it as a conspiracy, which was ab-

solutely false. As the pressure on Messier began to mount, everyone began to contact me. The Americans [on the board] asked me to take Messier's place, but I said no. Leaders in the French financial community also talked to me and said something had to be done. Finally, a majority of board mem-

IN AXA'S GARDEN:
played a major role
Messier's ouster

bers understood that this was a serious problem. But while the Americans wanted to get rid of him right away, the French wanted to find a replacement first. They asked me: if I wanted the job, I said: No, but I can suggest someone—Jean Fourtoul. [The former chairman of drug giant Aventis was named Vivendi's CEO on July 3.]

How bad was the financial situation?

If the decision to replace Messier [hadn't been made when it was, Vivendi would have run out of money within days. The banks were supposed to extend \$400 million of credit, but they de-

not to. They would have pulled the money out from under Vivendi. We made the decision on a Sunday [June 30]. Vivendi had just been downgraded by the ratings agencies. On Tuesday, the banks would have cut off credit.

The reason I agreed to join the board, and the reason Fourtoul accepted was that if Vivendi collapsed, it could have been a systemic effect, a loss of confidence in the French market. We had to prevent this. Now we are taking the situation in hand. We have secured new lines of credit, and we are evaluating which holdings should be sold to reduce debt, which is at an unsustainable level.

Are you hopeful that France's new government will enact such free-market reforms as privatization and deregulation?

I'm optimistic. Chirac doesn't want to run again, and if he wants to secure his place in history, he has to run now. Will the new government have the courage of Thatcher and Reagan? We will see. The real test will come when we face the first conflict. A lot will depend on explaining what they want to do and doing things at the right time, not trying to do everything at once.

BusinessWeek online

For a full interview with Claude Bébéar go to the July 29 issue online at www.businessweek.com

Ph.D.

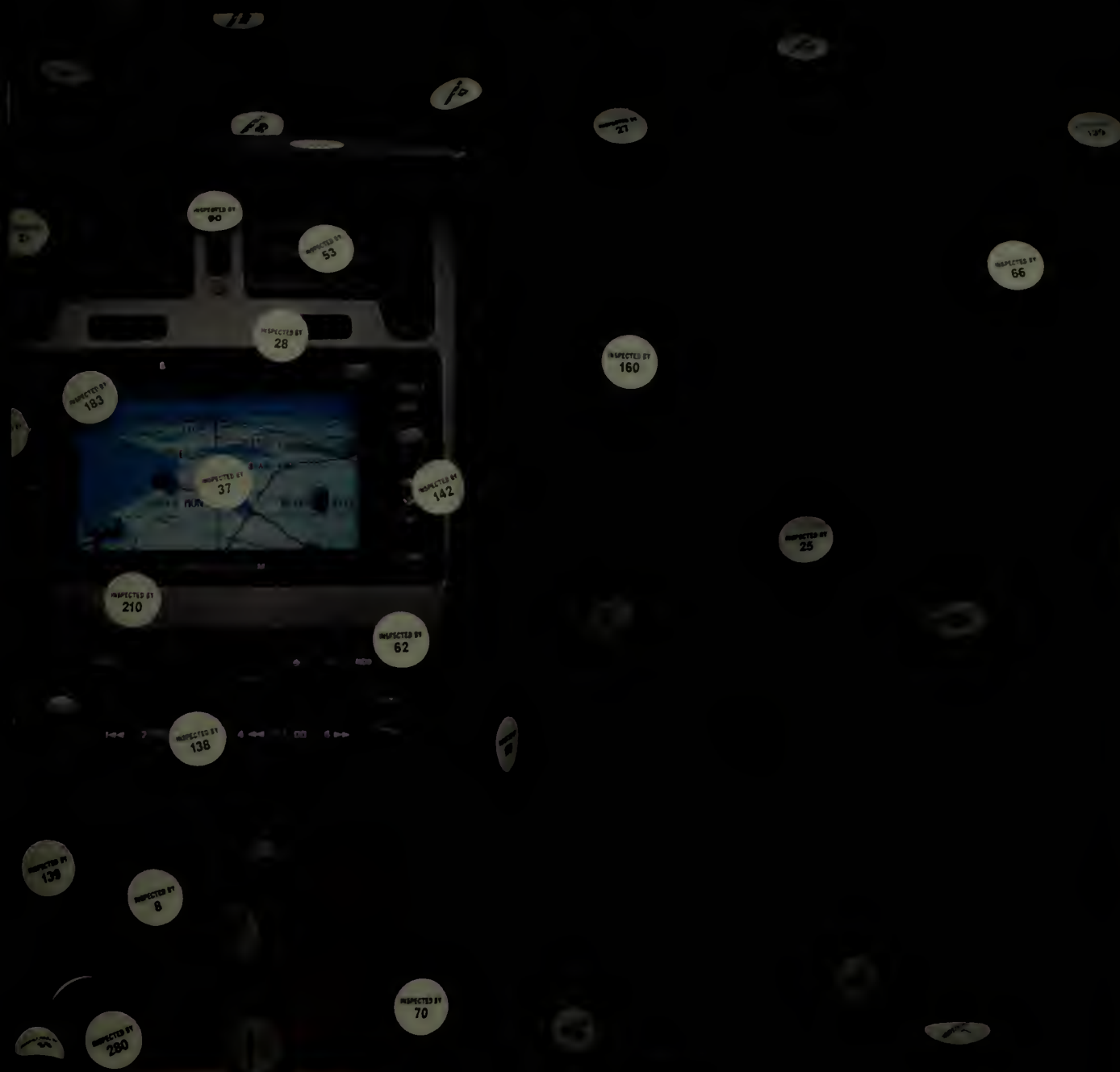


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HONG KONG

SINKING PRICES OUGHT TO BE A BLESSING, RIGHT?

But in Hong Kong, deflation is wreaking economic havoc

Earlier this month, more than 30,000 people marched in Hong Kong's biggest protest since the 1989 Tiananmen Square crackdown. These weren't pro-democracy marchers taking to the streets but civil servants protesting the government's decision to cut their pay by as much as 4.4% this year. It was just the latest sign of how Hong Kong is grappling with a problem that has battered its economy for nearly four years: chronic deflation.

Odd as it may be to a New Yorker or a Londoner conditioned to expect steadily rising prices, each and every month since October, 1998, prices in Hong Kong have fallen. That may seem like good news for this notoriously expensive city, but instead it has been a double blow. Prices haven't fallen enough to fully revive Hong Kong's competitiveness, but they have dropped enough to help grind down the economy. Property prices have fallen the most, plunging 60% and leaving as many as 100,000 homeowners owing the banks more than their apartments are worth. Unemployment has reached 7.7%, the highest since the government began keeping records in 1981. That's helping to push down retail sales—they were off 4.1% in the first five months of the year, compared with the same period

last year. "We have a very defensive consumer mindset," says HSBC Holdings PLC's chief economist for Greater China, George Leung.

What's more, short of breaking the Hong Kong dollar's peg to the U.S. dollar, there's nothing much the government can do about deflation—except waiting until the global economy recovers and demand for the city's goods and services picks up. The peg ties the government's hands when it comes to easing monetary policy. So prices must adjust instead, as the architects of the peg envisioned. Hong Kong's price index has dropped nearly 11% since the deflation began, and wages have fallen by almost as much.

Trouble is, other Asian currencies depreciated sharply with the 1997-98 financial turmoil. That means Hong Kong is still expensive compared with much of the region. Hong Kong remains Asia's priciest port, for example. Its handling charges range between \$100 and \$200 a

BIG MARCH
Civil servants protesting a wage cut imposed by the government

ton, nearly those in Singapore while the price of southern charge as low as \$35 a ton.

So the government isn't over yet: The government forecasts that prices will fall 2.8% this year and that GDP will grow just 1.5%. The U.S. dollar's recent fall makes it harder for Hong Kong to regain its balance, but the city probably faces at least 12 more months of falling prices. "It will be a long grind back up," says Standard & Poor's chief economist Mike Morris.

Nonetheless, Hong Kong Chief Executive Tung Chee Hwa reaffirmed last month that the government has no intention of changing the 19-year-old peg. Allowing the dollar to float would make deflation go overnight by weakening the currency and driving up import prices, that would pose a huge risk to a city with a financial sector that depends on investor confidence. "We've gone through much pain already," says Ian Poon, chief economist for the Hong Kong General Chamber of Commerce. "If we were away with the peg, it would be a very, very difficult situation." Currency priming isn't much of an option, either. The budget deficit is already running at 3.3% of gross domestic product, high for a city used to surpluses.

Signs of suffering are easy to spot. Banks, which once thrived on fat profits from mortgages, now face shrinking portfolios. Lending was down 9.7% in the first five months of the year, while personal and corporate bank deposits tripled. In March, banks wrote off an average of \$1 million of their credit-card debt, compared with \$500,000 a year earlier.

Even solvent consumers are not immune. "I'm stuck in borrowed money when they're stuck on a piece of negative equity. Just ask Mr. Lau. Back in 1997, he paid \$307,000 for a 500-square-foot flat in Sheung Shui near the Chinese border. The

flat is worth 25% less than \$200,000 he still owes the bank. "It's a very silly purchase," laments the year-old sales manager for a building materials company. "But if you're stuck, you just have to dig yourself out. Listen up, Hong Kong."

By Frederik Balfour in Hong Kong





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COMMENTARY

By Paul Magnusson

A U.S. TRADE PLOY THAT IS STARTING TO BOOMERANG

You're the CEO of a widget company. The economy is sputtering, demand is down, and your warehouse is full of widgets approaching their expiration date. You rule out layoffs to slow production and instead slash prices to empty those shelves. Next Fourth of July, you'll be cheered at the company picnic.

But if you're a widget exporter and you cut prices to clear out your inventory, a different fate awaits you. By merely discounting prices on goods that you sell abroad, you may be "dumping." So future exports could face high-penalty tariffs collected by foreign governments. As many a U.S. company has discovered, it's that easy to run afoul of international anti-dumping rules.

Welcome to the curious and contradictory world of anti-dumping laws, cloaked in obscurity and illogic and administered by a cabal of highly specialized lawyers, consultants, accountants, and government customs agents. In the next few weeks, expect to hear more about this arcane issue. Why? On July 17, House and Senate jockeying began over a fast-track bill that would let President George W. Bush negotiate trade treaties with minimum involvement by Congress. But there's one major exception to the Senate version: He cannot negotiate any reforms of America's anti-dumping laws.

U.S. Trade Representative Robert

B. Zoellick, who already acceded to demands from developing nations to put the contentious anti-dumping issue on the bargaining table, insists that no trade bill is preferable to one with that prohibition.

Instead of tying the President's hands, Congress ought to be encouraging reform. "Most economists think the anti-dumping laws are completely

the 1980s, but they brought 700 cases overall in the second half of the 1990s, according to figures compiled by the Cato Institute in Washington. Today, U.S. exporters face about 100 active investigations and 89 penalty tariffs, according to the U.S. Commerce Dept.

Long the target of U.S., Canadian and European dumping laws, poor nations are learning that dumping duties can be a convenient way of protecting favored domestic industries. China's new membership in the World Trade Organization has "appeared to amplify [its] new interest in bringing anti-dumping cases against the U.S. on behalf of uncompetitive state-run enterprises, according to a 2002 report from the U.S. Trade Representative's office. Despite its late start, India is levying more dumping penalties (9) against U.S. products than is the entire 15-nation European Union (2).

ZOELLICK:
No fast-track trade bill would be better than the Senate version

The danger: As more developing nations reduce tariffs to comply with WTO agreements, they'll switch to anti-dumping penalties to keep home industries cosseted.

U.S. anti-dumping statutes were written 80 years ago to protect against predatory pricing by foreign exporters. Theoretically, dumping occurs when a company sells goods overseas at prices below the cost of production or below the home-market price. But import-sensitive companies, particularly in the steel industry, which files nearly half of all U.S. dumping petitions, "captured the process and dictated the rules



nuts, but I suspect that very few lawmakers even understand how they work," says Robert E. Litan, director of economic studies at the Brookings Institution. "And now, the developing world is picking up on our bad example."

Indeed, India and China have recently taken up the anti-dumping cudgel with a vengeance, and the U.S. has become a top target.

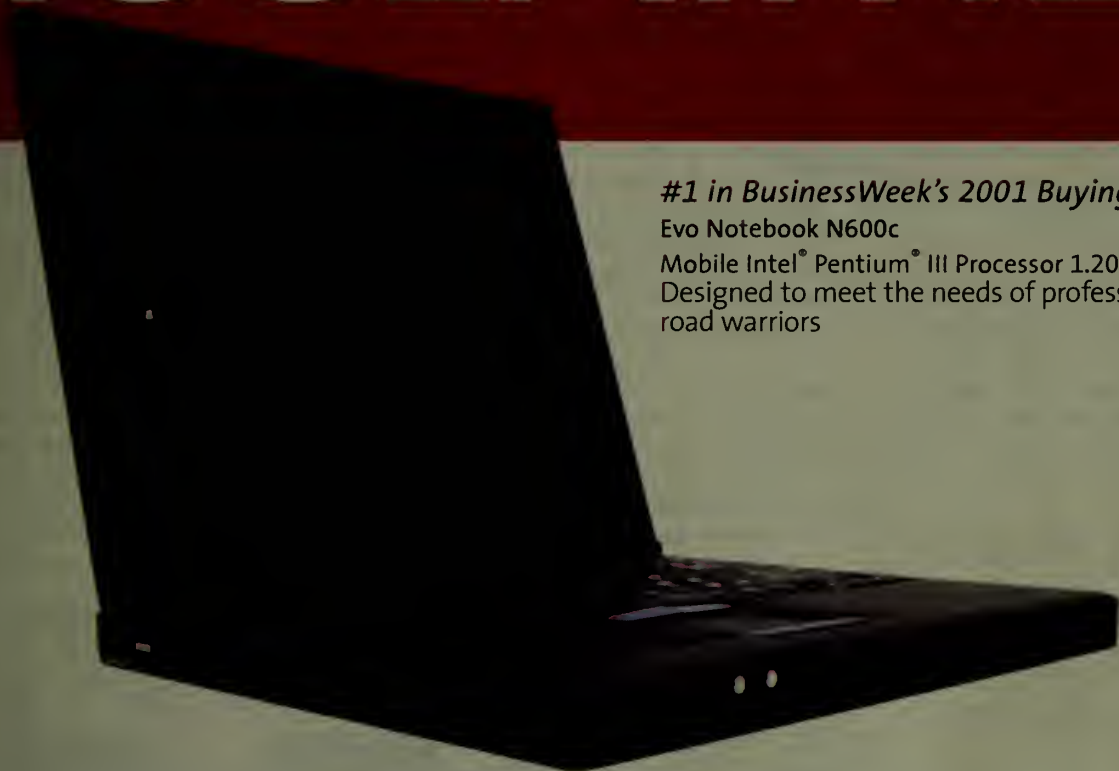
Some of the U.S. companies now in the sights of trade protectionists abroad include Amana, International Paper, Dow Chemical, 3M, and Bristol-Myers Squibb. Developing countries filed only a handful of cases in

A SPIKE IN DUMPING CASES

Countries are increasingly levying fines against one another



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assessing dumping, according to Michael S. Knoll, a University of Pennsylvania law professor. "The system has been rigged so that it's easy to persuade the Commerce Dept. that there has been dumping," says Knoll.

Given the various plaintiff-friendly methods of calculating "fair" prices, it's easy to see why. An example: If a foreign manufacturer doesn't respond to a detailed Commerce Dept. questionnaire about its pricing policies, the department can just accept the allegations of the U.S. plaintiff. In calculating whether an exporter is charging a "fair" price, Commerce can determine the theoretical cost of production in the home country and add 10% overhead and 8% profit. Anything under that price points to dumping.

That's not to say that anti-dumping laws have no place. But they need to meet a more consumer-friendly test. For example, are exports being priced to damage a U.S. industry in order to

New WTO members seem to be using dumping duties to replace tariffs

seize monopoly control? Are other nations restricting their own markets to only domestic producers in order to generate high profits and subsidize exports? In those cases, dumping penalties are clearly warranted. As with antitrust laws, anti-dumping cases should rest on whether an exporter is undermining competition in order to hike prices later.

International talks to reform the process have precedents. The 1994 Uruguay Round required WTO members to review dumping penalties every five years and to drop duties that are no longer justified. That's sensible. Next, the WTO nations need to get back to the basics of defining unfair pricing. Exporters shouldn't be penalized just for following sound business practices.

Magnusson covers international trade from Washington.

The Corporation

DEFENSE

NORTHROP'S RISKY FLIGHT PATH

Buying TRW is a coup, but will it pay off for shareholders

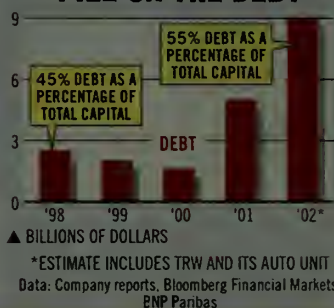
If Kent Kresa were a fighter pilot, he would certainly qualify as an ace after his performance over the past year and a half. The low-key chairman and CEO of Northrop Grumman Corp. completed two big mergers in 2001, adding Litton Industries Inc. and Newport News Shipbuilding to Northrop's lineup. In the past nine months, Northrop has also shared in such big new contract awards as the \$225 billion Joint Strike Fighter, a new jet fighter that will replace older planes in the Air Force, Marines, and Navy, and a \$17 billion modernization of the U.S. Coast Guard fleet.

Then, on July 1, Kresa scored again,

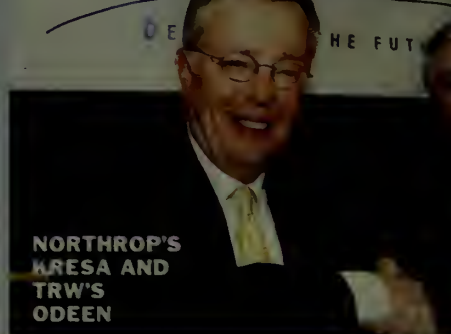
TRW brings long-term expertise developing spy and military communications satellites. It supplies critical data for the Milstar satellites, for instance, the military's main method for receiving critical data from remote regions, as Afghanistan. Northrop is also strong in radar systems, intelligence gathering aircraft, and battlefield management computer systems. Pen spending on missile defense systems alone is projected to climb to \$11 billion by 2007, from \$7.8 billion today.

At the same time, Northrop is working to supply the Navy and Guard with a new generation of ships, faster, and more technologically sophisticated.

NORTHROP'S DEALS PILE ON THE DEBT



NORTHROP GRUMMAN



NORTHROP'S KRESA AND TRW'S ODEEN

announcing that Northrop had won a bruising five-month battle to acquire TRW Inc. When Kresa and TRW Chairman Philip A. Odeen finally shook hands on the deal, Northrop was poised to become the second-largest defense contractor in the U.S.—after Lockheed Martin Corp.—with sales estimated at \$26 billion next year.

In theory, TRW, with its information- and space-based technology businesses, should give Kresa's outfit a big boost. Northrop is projecting a 23% rise in profits in 2003, from 2002's estimated \$750 million. Kresa believes the acquisition, scheduled to close before yearend, will make Northrop even more of a player in space and missile-defense systems.

ticated ships. Next year, its shipbuilding expertise will be on display when the Navy accepts its latest aircraft carrier, the USS Ronald W. Reagan, from Newport News. "While Kresa keeps a sonably low profile, he's been one of the industry's bigger forward thinkers," says Jon B. Kutler, a defense industry investment banker at Quarterdeck Investment Partners LLC.

If Kresa's grand strategy works, Northrop will emerge as a well-rounded defense contractor, capable of supplying high-tech armaments or components for most of the military. That's a key reason

Northrop fought so hard to obtain New-
ews and TRW. But Kresa will need
skill he can muster to make this
r pay off. It's full of potential pit-
he TRW debt Northrop is likely to
, the acquisition's potentially dilu-
fect on Northrop stock, and
ssibility that Congress
elays, or elimi-
funding
y con-

st case: Kre-
o is expected to re-
xt March, could repeat the expe-
of former Lockheed Martin
an Norman R. Augustine. He
d that company through a series
isitions, but earnings tumbled af-
retired in 1997. Kresa and all
Northrop executives declined to
ent for this article. But Kresa has
at Northrop's well-honed merger
ation process will let it continue
ord of successful acquisitions.

Reason Northrop shares have fall-
ce mid-June from \$132 to about
-following a 50% rise over the pre-
18 months—is the potential for di-
Later this year, Northrop will is-
71 million shares to TRW
olders, more than half the current
er of outstanding Northrop shares.
on estimates from Deutsche Bank
ties Inc. analyst Christopher H.
y, Kresa is paying about 8.7 times
ash flow for the two TRW busi-
he plans to keep, space electronics
formation technology. Northrop as
le trades for 7.8 times cash flow.
analysts had cut their earnings es-
s to reflect that. But the company's
of strong second-quarter earnings
ush up the 2003 consensus, which
at \$7.49 per share, according to
gs tracker Multex.com.

hough the TRW merger is a stock
Northrop's debt has steadily risen
result of its earlier buys (chart) to
billion. TRW has a similar amount.
to the merger deal, TRW said it
sell its aeronautical systems unit
.5 billion. The proceeds would be
to pay down debt, leaving a com-
debt of about \$9 billion. Kresa
opes to sell TRW's auto-parts busi-
Analysts say that could raise \$5
to retire debt.

only it were that easy. TRW's auto-

SBIRS LOW SATELLITE:
*It tracks enemy
missiles*



parts business,
which has \$10 bil-
lion in annual sales, has been in
play since Northrop made its first
hostile offer in February—with no tak-
ers. That's because parts companies are
being squeezed unmercifully by car-
makers trying to cut costs. If Kresa
can't find a buyer at close to \$5 billion,
he may have to spin off the unit to
shareholders in a manner that could
leave Northrop holding \$1 billion or
more in additional TRW debt. That pos-
sibility led Moody's Investors Service
to put Northrop on credit watch for a
possible rating downgrade when the
deal was first proposed.

Kresa gets lots of credit for spotting
a potential boom in space spending by
the Pentagon, and TRW's satellite busi-
ness was one of the prime targets in
the deal. But the space unit has fal-
tered recently. Last year it earned \$117
million before special charges, on sales
of \$2 billion. That's less than half of
what it earned in 1999. Sources familiar
with Northrop's plans say TRW had been
investing in unprofitable commercial
communications programs that Kresa
will cut. Still, TRW's space and info-tech
units together earned about 6.3% on
sales last year. That is below Northrop's
7.4% overall margin, suggesting that if
Kresa can't boost profits at the acquired
units, Northrop's margins could tumble.

Even though regulators are expected
to clear the TRW merger, the Pentagon
still figures to have a say in how it
comes together. Unless the military
brass feels comfortable that certain sec-
tors of the industry remain competitive,
it has the ability to quash the deal.

Some mili-
tary contractors are
already fretting that a more
integrated Northrop will be able to
squeeze out smaller contractors in criti-
cal new programs such as the Space-
Based Infra-Red System (SBIRS) Low,
which uses low-orbiting satellites to
track incoming enemy missiles and
relay the information to a defen-
sive missile or even a laser
weapon. Northrop is discussing
remedies that would ensure com-
petitor access to future missile con-
tracts, say sources close to the company.

Moreover, even though funding for
space and missile programs is expected
to climb, Northrop runs the risk that
financial pressures could force Congress
to cut some of its bread-and-butter air-
craft programs. "There will have to be
trade-offs in the Pentagon budget," says
William Hartung, a defense industry an-
alyst at the World Policy Institute, a
foreign policy think tank in New York
City. "[Northrop] could easily find that
this isn't all gravy." The U.S. Navy is al-
ready weighing cuts in the Joint Strike
Fighter, which Northrop is building with
Lockheed Martin. Northrop also faces
trouble with its high-profile Global Hawk
reconnaissance plane, the unmanned jet
that will replace the U-2 spy plane.
Higher costs have prompted the Air
Force to request a 50% cut in the
plane's \$48 million per-unit price tag.

Kresa so far has done an outstanding
job of piloting Northrop through the
defense industry's troubled skies. Next
March, he reaches Northrop's manda-
tory retirement age of 65. His expected
replacement, Northrop President Ronald
D. Sugar, is himself a 20-year veteran of
TRW, where he once served as chief fi-
nancial officer. Sugar is by all accounts a
credible leader whose time at TRW
should prove helpful. But if things don't
go according to plan, Kresa could find
himself retiring as an ace but leaving his
wingman in a tight spot.

*By Christopher Palmeri in Los Ange-
les, with Stan Crock in Washington, D.C.*

PITFALLS Northrop should be a stronger
player with TRW, but Kresa needs to
shed some of its troubled
assets

SEMICONDUCTORS

NVIDIA: DODGING A HAIL OF BULLETS

Can the chip wizard fight off rivals and the SEC?

In the shoot-'em-up business of graphics chips, Nvidia Corp. has rocketed from obscurity in just four years to become the fastest gunslinger in town. To the delight of gamers worldwide, the company has consistently delivered technology that brings dazzling, movielike digital graphics to computers and game consoles. That helped Nvidia rank as the best-performing stock in the Standard & Poor's 500-stock index last year, with its shares up 308%, to \$66.90.

Now, however, the Santa Clara (Calif.) company is dodging a hail of bullets engraved with its name. PC sales are stagnating. Competition from rivals such as ATI Technologies Inc. and Intel Corp. is intensifying. Manufacturing problems are threatening to delay Nvidia's next-generation chip. Just to top things off, the Securities & Exchange Commission is digging into the company's accounting practices. No wonder Nvidia stock is down 68%, to \$21 this year. "For the first time in a long time, Nvidia is being challenged," says analyst Joseph Osha of Merrill Lynch & Co.

Chief Executive Jen-Hsun Huang is

trying to beat back the challenges. As sales slow in the company's core desktop-PC market, he's pushing into new markets, including graphics chips for high-end notebooks and such low-end products as set-top boxes. On July 16, Nvidia released a new set of chips aimed at low-end PCs and set-top boxes. And Huang is striving to make sure Nvidia's next-generation chip, code-named NV30, hits the market later this year, right on time. "We're gaining traction in every single market we're serving," Huang says.

Still, Nvidia's problems look like they're going to get worse before they get better. The company is having a tough time penetrating the new markets it has targeted. In low-end graphics chips, for example, Intel is pricing so aggressively that it is expected to grab

HARD PUSH:

Huang has new chips for set-top boxes and notebook computers

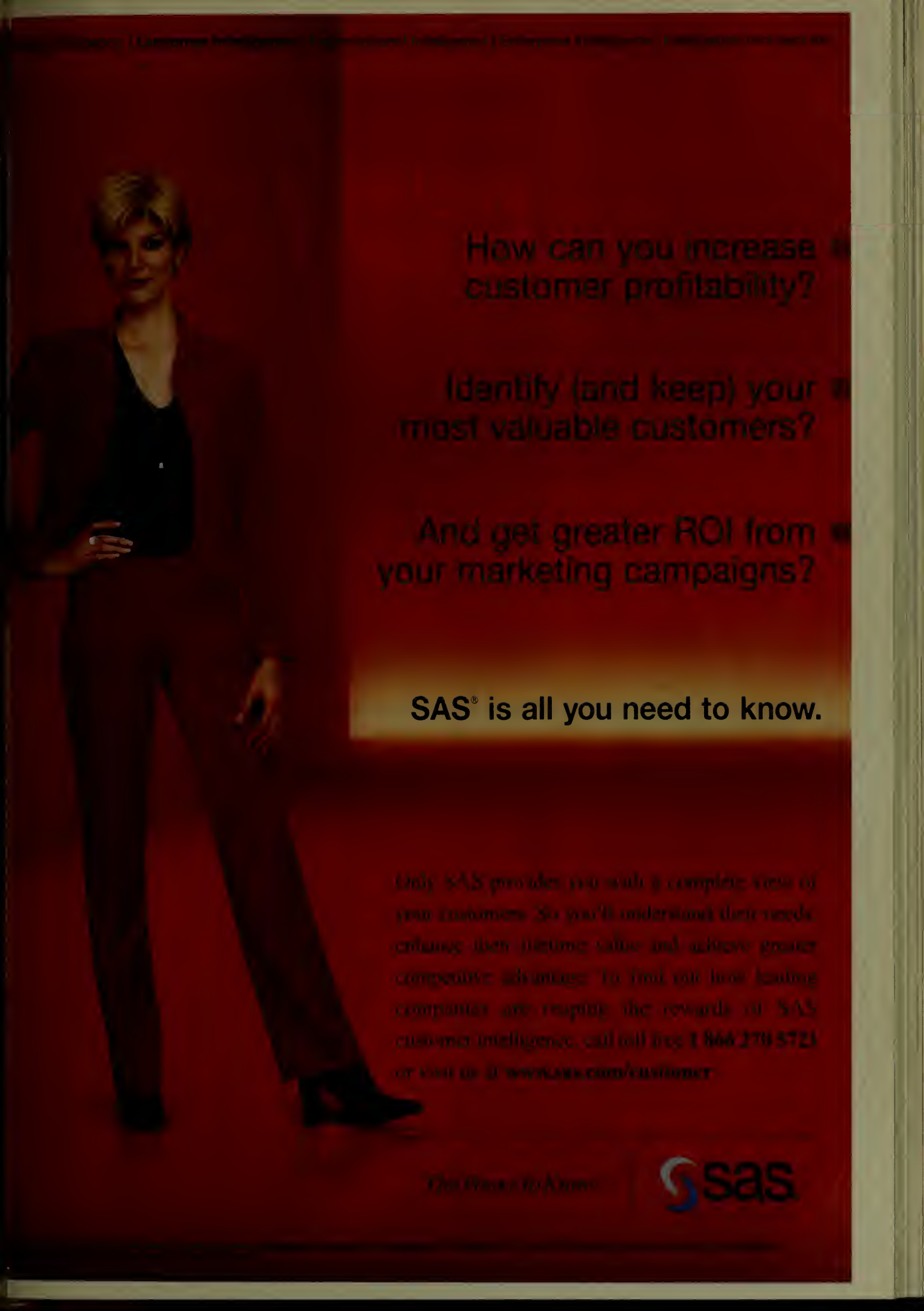
new Radeon graphics chip on July 16, and industry analysts say it's ahead of Nvidia's current to-GeForce4 chip in speed and quality. Losing its title as the performance king in graphics chips will probably cause a slowdown in Nvidia's growth this year. Merrill Lynch's estimates Nvidia's revenues will fall 54%, to \$2.1 billion, in the fiscal year ending in January, with net income down \$275 million. That's a hefty retreat from last year's 87% revenue growth.

How Nvidia fares in the long run will depend on the NV30. If the company can get the chip out in volume late

A HIGHFLIER COMES DOWN TO EARTH

The stock of graphics-chip maker Nvidia is down 68% this year after rising 308% in 2001. Here's its turnaround plan:

PROBLEM	FIGHT OFF COMPETITION	MAINTAIN GROWTH	MEET DEADLINE FOR NEW CHIP	RESTORE INVESTOR CONFIDENCE
	Nvidia holds 42% of the graphics-chip market, but on July 17, a reinvigorated rival, ATI Technologies, launched a new high-end chip. Analysts predict Nvidia's market share will fall to 37% by yearend.	Analysts say Nvidia's sales will rise 54%, to \$2.1 billion, this year, down from 87% growth last year. With sluggish PC growth, bearish Wall Street firms are forecasting growth will slow to 7% in 2003.	Nvidia sent the NV30 design to Taiwan Semiconductor Manufacturing, its chipmaker, several weeks late. A new factory process that Taiwan is using could delay volume shipments until after Christmas.	Last year, the SEC charged Nvidia employees with insider trading. In January, the SEC opened an inquiry into whether Nvidia double-booked expenses and improperly logged research. The inquiry remains open.
SOLUTION	Nvidia released new chips for the low-end PC market in July, and by yearend it will release its high-end NV30, to compete with ATI's new product.	Nvidia is moving into markets such as integrated graphics chips for cheap PCs. Nvidia has grabbed 4% of that market, up from zilch last summer.	Nvidia has sent engineers to Taiwan to work out glitches at the plant. And it has simplified the chip's design to smooth production.	Nvidia fired some of the affected employees. And an internal audit resulted in the company slightly boosting its earnings in the past three years.
GRADE	GOOD	FAIR	FAIR	FAIR



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The Only One to Know



year, Nvidia will recover its performance advantage over ATI and should do well next year. If, however, the NV30 is delayed several months, the company's fortunes could spiral downward. Its profits could fall, forcing cuts in critical research and development. "It's going to be a tremendous squeaker, and in this business, you don't like squeakers," says Osha, one of six analysts who recently downgraded the company's stock. For the fiscal year ending in January of 2004, Osha predicts revenues will climb only 7%.

Why the squeaker? In trying to outperform ATI's new chip, analysts and rivals say Nvidia was several weeks late in sending its design specifications to Taiwan Semiconductor Manufacturing Co. (TSMC), its manufacturing partner. Complicating matters, TSMC is having problems with the new process Nvidia is switching to for its high-power chip. Nvidia is working on the problems, but it won't guarantee full production volumes for the holiday shopping season.

The sudden pessimism is a far cry from last year's glory days, when Nvidia was enjoying the gamer's equivalent of a bonus round. Last fall, Nvidia's shares rose on expectations of a strong launch for Microsoft Corp.'s Xbox, because it supplies graphics chips for the game player. In the latest quarter, Xbox accounted for 22% of Nvidia's revenues. But Xbox also marked the starting point of the company's troubles. In November, 11 company engineers were charged by the SEC with trading on knowledge of the Xbox deal before it was formally announced. Nvidia says some employees were fired, but a spokesman declined to say how many were fired and what disciplinary action, if any, was taken against others.

During that investigation, the SEC uncovered the potential accounting troubles. The commission is looking into whether the company double-booked revenues and improperly accounted for reserves. To preempt any SEC action, Nvidia restated its financials, boosting profits by \$1.3 million, and removed its chief financial officer, Christine B. Hoberg. Hoberg, who is expected to take another position with the company, could not be reached for comment. The SEC inquiry is still open.

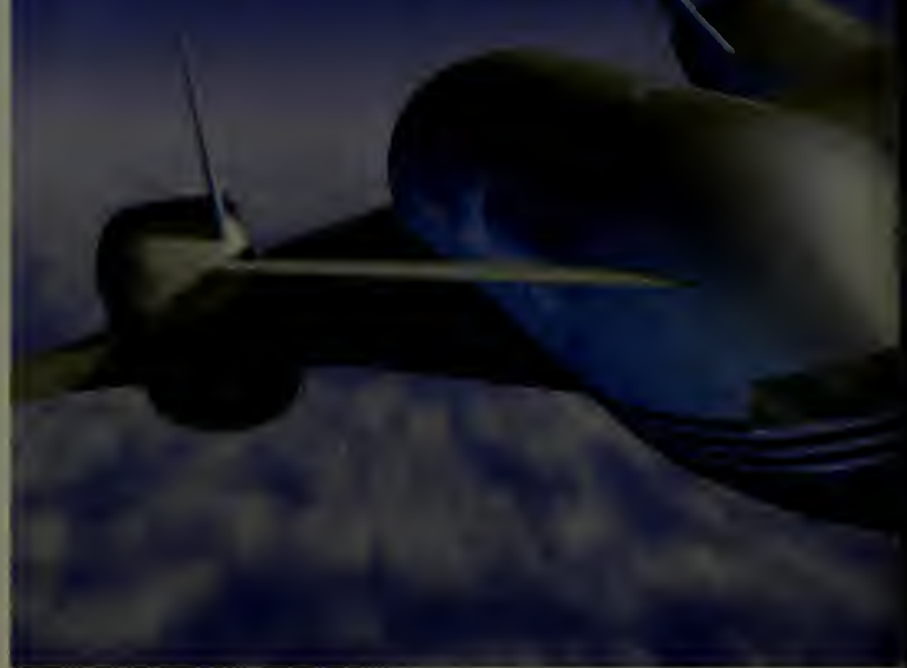
For now, Nvidia has a little breathing room. The expense and engineering expertise required to develop new chips are stiff barriers for potential new entrants. But to beat back reinvigorated rivals, Nvidia must restore its focus on the high-end markets that elevated the company to its previous heights. Otherwise, Nvidia will find its pistol empty in the most important shootout of its life.

*By Cliff Edwards
in Santa Clara, Calif.*

Science & Technology

AIRCRAFT

BOEING: A FLIGHT TO SAFETY?



It may drop plans to build the speedy Sonic Cruiser—although that could mean losing ground to Airbus

Plans for Boeing Co.'s Sonic Cruiser dazzled the airline world when the Chicago company unveiled them more than a year ago. It was a bold stroke: a jet that promised to transport 250 passengers at nearly supersonic speeds without burning up profits in higher fuel costs. Chairman and CEO Philip M. Condit said as recently as a month ago that things were going so smoothly that Boeing might begin to take orders next year for 2008 delivery.

Behind the scenes, though, the Sonic Cruiser is moving at anything but the speed of sound. Executives at many major carriers, including American Airlines, Delta, United, British Airways, and Japan Air Lines, say they don't plan on buying it. Only Continental Airlines Inc. still expresses interest. With even business travelers now scrambling for deeply discounted fares, a key idea behind the Sonic Cruiser—that passengers would be willing to pay a steep

premium for quick flights—seen a quaint vestige of the '90s. "Given the present flying environment," says Gordon McKenzie, United Airlines Inc. director of new aircraft programs, "the Sonic Cruiser might be something for our distant future, but not something we'll see in the next 10 years."

The weak prospects have Boeing hedging its bets. Boeing engineers are considering two alternative designs for the Sonic Cruiser, according to industry sources and Boeing insiders. One is a conventional jetliner that would be fuel-efficient and cheaper to build than the slow-selling 767. The second is another radical new design: a wing shaped like the B-2 bomber. Boeing's board is expected to choose among the three designs this fall. With Boeing's Farnborough Air Show, a global gathering of aerospace executives, beginning on Sunday, July 21, Boeing is under pressure to clarify its plans.

Odds are, the board will abandon the Sonic Cruiser and go the conservative route, according to former Boeing executives and industry leaders. The company says it can make the conventional 250-seat jet up to 30% more efficient to operate and cheaper to buy than today's airplanes. That's a huge advantage.

**SONIC CRUISER:
A PRICEY RIDE IN
LEAN TIMES**

upped its total share from 30% to nearly 50%. The European company has begun manufacturing its next-generation jumbo jet, the 555-seat A380, a double-decker flying behemoth. It has sold more than 100 of the jets and plans to deliver the first airplane in four years. The A380 is expected to take more sales away from Boeing's aging 747, which carries 420 passengers. That leaves Boeing's 300-passenger 777 as its one major success. Boeing needs another hit jet to regain a decisive market lead.

Boeing officials insist that the Sonic Cruiser is still their first choice, though Condit acknowledged during an earnings announcement on July 17 that there were questions about its viability. "We want to understand the market before we commit to [the Sonic Cruiser]," he said. Boeing believes the jet would cut air-travel trips by about one hour for every 3,000 miles flown, shaving nearly two hours from the flying time between New York and Tokyo. The company thinks passengers are prepared to pay a premium—not just to fly faster, but to avoid congested hubs and fly directly from city to city.

At least one major airline chief executive agrees with Boeing. Gordon Bethune, Continental's CEO, insists that business travelers are still willing to pay extra for faster service, but they haven't had to do so lately because of all the bargain fares available, with all the industry's excess capacity. He believes Boeing should stick with the Cruiser, and he's interested in buying some if Boeing can offer operating costs comparable to those of the 767. "They know that is the only thing they can differentiate themselves with," Bethune says.

But the Sonic Cruiser requires leaps in engine and aerodynamic technology to make it competitive. Flying just below the sound barrier, the ride tends to be bumpy and unpredictable because shock waves form around the airplane as it approaches Mach 1. The turbulence also drives up fuel costs. So far, Boeing's engineers haven't shown the airlines a design that solves these problems, say airline

execs. "The Sonic Cruiser caters to the rapidly evaporating premium market," says Richard Aboulafia, a Teal Group aerospace analyst. "Now, more than ever, the bus-travel theory of air transport seems to be the right one."

Market conditions can change, of course. But, if Boeing decides to put its chips on a more radical design, analysts say it might be better off picking the wing jet, known as the "blended wing." Such an aircraft would be substantially lighter than a conventional tube-and-wing design. The 480-seat version would burn 32% less fuel than the A380, according to Boeing. That's a huge cost advantage. The blended wing can fly faster and be built more cheaply than conventional jets because of its unusual design. There's one major drawback: no windows for passengers. But Boeing engineers may be able to deal with that by providing video views of what's going on outside. A handful of airlines are interested in the design, though they wouldn't be ready to buy it for perhaps a decade.

For now, Boeing executives have to decide which direction they're going with their next jet. Until they do, it will be investors who are flying blind.

By Stanley Holmes in Seattle, with Wendy Zellner in Dallas

TOUGH CHOICE

Boeing must pick one of three designs for its next airliner:

SONIC CRUISER An all-new jet design promises to transport 250 passengers at nearly supersonic speeds. Problem is, business fliers might be reluctant to pay the premium prices that airlines would need to charge for flights on this jet.

CONVENTIONAL UPDATE A new, nonradical design that would replace the slow-selling 767. The company says it could make this 250-passenger jet up to 30% more efficient than its predecessor. Downside: Rival Airbus Industrie could match it.

WING JET The "blended wing" (below), shaped like the B-2 bomber, would be much lighter than a conventional airliner. It could be built more cheaply and would burn less fuel. The drawback: There are no windows for passengers.



COMMENTARY

By John Carey and Amy Barrett

THE BEST PREVENTIVE MEDICINE MAY BE NONE AT ALL...

The news that hormone-replacement therapy causes harm raises a disturbing larger question: What other drugs have health authorities been wrong about?

The truth is, the hormone-replacement debacle "has underlined that we don't know a lot," says Dr. Lonny Reisman, CEO of Active Health Management Inc. And ignorance could be dangerous: Many doctors harbor concerns about everything from blockbuster cholesterol-lowering drugs to painkillers.

This doesn't mean that people should empty out their medicine cabinets.

Even hormone replacement therapies have their place—relieving symptoms of menopause. And other newer drugs have been proven to work, at least in short-term clinical trials. Moreover, vague risks of cancer many years hence are irrelevant to sick patients who need drugs today.

But what worries many doctors is the growing trend of healthy people taking medicines to ward off future ills. "Most drugs do have a number of effects, both good and bad," explains Dr. Stephen B. Hulley, chair of Epidemiology & Biostatistics at the University of California at San Francisco. "We should be cautious about preventive medicine treatments that last decades."

Many women who were taking hormones to prevent osteoporosis, for example, might now turn instead to blockbuster bone-building drugs, such as Merck & Co.'s Fosamax. "The problem is that these drugs are incorporated into the bone, which is right next to the bone marrow," says Jim Carlson, assistant director of pharmacy administration at the Group Health Cooperative, a Seattle health-care provider. "The question is whether they are potentially toxic to the marrow." Merck

says a decade of clinical studies and more than 4 million patients treated show that Fosamax has no effect on bone marrow. Carlson continues to have questions.

Potential red flags wave over other long-term-use drugs. Take antidepressants. "We don't know what happens to people who are on [them] for five years," says Dr. Karen E. Lasser of Harvard University Medical School. Meanwhile, popular—and relatively new—drugs for rheumatoid arthritis work by inhibiting an immune-system protein called tumor necrosis factor. But messing with the immune system

Zeneca PLC's Prilosec—can increase levels of a hormone called gastrin, has been linked with a higher risk of cancer. AstraZeneca says that studies up to 12 years long show no evidence of cancer. But Dr. M. Michael Wallace, chief of gastroenterology at Boston University School of Medicine, is convinced. "The issue needs to be examined," he says.

Indeed, the list of issues is as long as the list of drugs. Do blockbuster painkillers Vioxx and Celebrex cause heart problems? The issue is still out. Do blood-pressure-lowering calcium-channel blockers do more

than good? For example, And such will increase the risk of cancer with other drugs. If otherwise healthy people are taking them for many years, "who knows what side effects will come up?" asks Bert Vogelstein, an oncologist at Johns Hopkins University.

The only definitive answers will come from large, expensive studies, such as the one in progress that spans the latest cancer prevention trials. Yet drug companies will almost never



News on hormone-replacement therapy hoists a red flag over long-term-use drugs

could have unintended consequences, doctors warn.

One huge success story has been a class of drugs called statins, including Pfizer Inc.'s blockbuster, Lipitor. Statins not only lower cholesterol but have also been proved to reduce the risk of heart attacks and stroke. But in rodents, the drugs cause cancer. "The biggest question with the statins is what happens if you have been on them for 20 or 30 years. Nobody knows that—and the animal data are a cause for concern for younger people," says Dr. Thomas B. Newman, professor of epidemiology and pediatrics at UCSF. Pfizer says the benefits outweigh this theoretical risk.

Another popular class of drugs—acid-reducing medicines such as Astra-

Zeneca PLC's Prilosec—can increase levels of a hormone called gastrin, has been linked with a higher risk of cancer. AstraZeneca says that studies up to 12 years long show no evidence of cancer. But Dr. M. Michael Wallace, chief of gastroenterology at Boston University School of Medicine, is convinced. "The issue needs to be examined," he says.

It's clear that more large studies need to be done. And drugmakers and regulators must do a far better job of spotting problems with drugs than the current flawed system. A far more rigorous system might provide hints where larger studies are needed. Then, Americans should take the lessons from the hormone debacle to heart, and approach their medicine cabinets with a proper measure of caution.

COMMENTARY

By Catherine Arnst

... BUT DON'T RUN SCREAMING FROM HORMONE THERAPY

and cry over hormones as no signs of abating. Anti-hormone crusaders are crowding the study on hormone replacement therapy (HRT) proves the drugs increase risks of breast cancer and heart disease. Beleaguered women who seek relief from the torments of menopause use through HRT say the danger is overblown. In the end, the spotlight shines on an underappreciated axiom: There is no such thing as a free lunch, and patients must figure out for themselves if the risk is worth taking.

Don't assume your doctor will give you the answer. Physicians are often torn to "First, do no harm," but those are difficult to practice by, given that two doctors may disagree on exactly how much hormone causes harm. Where do you leave the patient? Another set of words to ponder: "Know thyself." Only a large medical study produces statistics that can clarify the very different implications for the many than for the few, and a public health approach based on a nationwide benefit analysis may illuminate the particular individual. Only by knowing one's own risks can a patient decide if a medical procedure is worth it. Even then, the decision is often an educated guess.

It's not just menopausal women who must guess. It's a matter of common sense, for example, that everyone should be tested for prostate cancer, and often for cancer. But a benefit analysis of data on prostate cancer screening found that 35% of men over 65 who underwent the standard test ended up being treated unnecessarily. If left alone, it is unlikely that most men would ever have experienced prostate cancer symptoms. Given that the treatment can cause impotence and incontinence, that sounds like a case for widespread PSA testing—unless you are one of the individuals whose life is saved by early detection. A similar calculation must be made for breast cancer, which many women have tak-

en for decades to prevent osteoporosis and heart disease, as well as to relieve the often severe symptoms of menopause. The large HRT study, conducted by the National Institutes of Health, came up with some scary-sounding figures. After observing 160,000 postmenopausal women for five years, researchers said those taking a combination hormone drug from Wyeth Pharmaceuticals called Prempro had a 29% higher risk of heart attack than those in the control group. They

also had 6 fewer cases of colon cancer.

Those tiny percentage increases on heart and breast disease can add up to tens of thousands of additional cases when spread across the 6 million U.S. women taking Prempro. Still, "there is no need to panic," says Dr. Daniel E. Stein, a gynecologist at St. Luke's-Roosevelt Hospital Center in New York. "Every woman should realize that the absolute risks are very small, and speak to her physician."

Figuring out one's own risk is complicated but doable. Healthy

women have a 1-in-8 chance of developing breast cancer in their lifetime. To calculate the odds for a particular woman, doctors can take a detailed family and lifestyle history, punch each factor into a computer program called a Gail model, and come up with a statistical ranking of the patient's chances. There are also ways to determine the risk of heart disease, osteoporosis, and colon cancer. However, no one can say "yes, you will develop breast cancer" or "no, you won't."

This lack of certainty will become more of an issue as new preventive therapies are developed. Researchers are testing a number of drugs meant to be taken for years by healthy people to prevent a range of diseases, includ-

ing Alzheimer's, diabetes, and cancer—although they may never develop these conditions if left alone. "It is unrealistic to think we will come up with a medical treatment that will have no side effects," warns Dr. Freya R. Schnabel, chief of the Breast Surgery Div. at Columbia-Presbyterian Medical Center in New York. "We need to grow up a little bit about this."

Often, the benefits outweigh the risks. But only the person swallowing the pill can make that determination—not a doctor, not society, and not some stranger quoted on TV.



A woman can choose wisely only by knowing her own risk factors

also had a 41% higher risk of stroke and a 26% increase in breast cancer risk.

However, the absolute risk of a woman developing these diseases in her lifetime increases only very slightly on HRT—and there is no increased risk in the first four years of the treatment. The study found that 8 more women per 10,000 per year developed breast cancer if they took the drug, an increased risk of less than 0.1%. Seven more women per 10,000 had heart attacks, and 8 more had strokes. On the plus side, there were 5 fewer hip fractures per 10,000 in the Prempro group

COMMENTARY

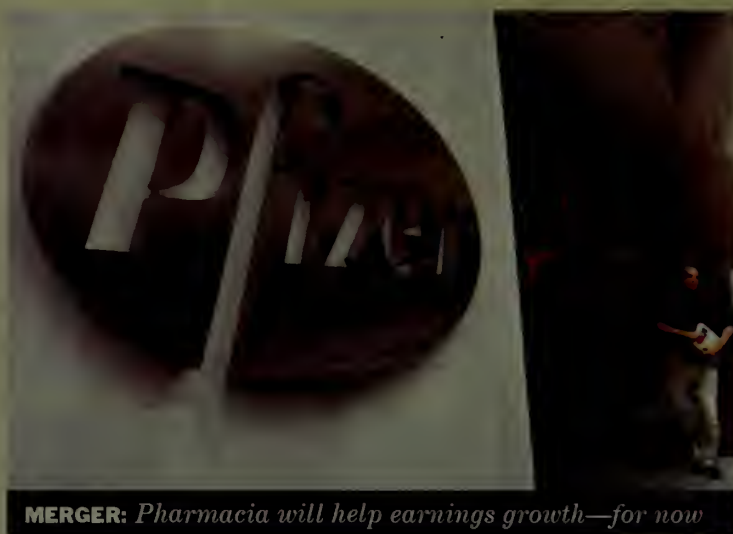
By Amy Barrett

BIG PHARMA: GETTING TOO BIG FOR ITS OWN GOOD?

There are two forces driving drugmakers Pfizer Inc. and Pharmacia Corp. into each other's arms—one readily apparent, the other less obvious. First, there are the cost savings from the deal, which Pfizer Chairman and Chief Executive Officer Henry A. McKinnell figures could hit \$2.5 billion by 2005. Over the next few years, that should propel Pfizer's compound annual earnings growth to nearly 20%. But secondly, as political pressure mounts—particularly in states like Michigan, where laws have been passed to bring down drug costs—companies with a broad array of important products may have more leverage in fighting off requests for discounts. "This is one big power play on Pfizer's part," says Jon M. Fisher, head of equity research at Fifth Third Bank.

The problem is, while the rush to get bigger may help in the near term, it is the wrong remedy for what is really ailing Big Pharma these days. The new Pfizer will have nearly \$50 billion in annual sales. More than ever, this behemoth will need blockbuster drugs like Viagra to generate earnings growth. But there is no evidence that bigger research and development operations produce more valuable drugs. On the contrary, Pfizer-size companies run the risk of giantism. "Without real management diligence, they can get slow, ineffective, and infrastructure-bound," says David L. Blumberg, a pharmaceutical industry managing partner at consulting firm Accenture Ltd.

Certainly, the evidence on drug R&D offers no support for megamergers. A study by McKinsey & Co. earlier this year looked at the net present value of products out of research vs. the spending on R&D for the top pharma players over the last decade. It found no correlation between the return on investment and a company's size. And according to London-based market research firm Data-



MERGER: Pharmacia will help earnings growth—for now

monitor, midsize player AstraZeneca PLC has the best pipeline currently, with potential sales of \$7.2 billion from three new products by 2008. That's well ahead of giants Pfizer and GlaxoSmithKline PLC, which have R&D budgets that exceed AstraZeneca's \$3 billion operation by \$1 billion or more.

What's more, companies like Pfizer run the risk of becoming addicted to mergers. Already, SG Cowen Securities Corp. analyst Stephen M. Scala warns that Pfizer's earnings growth will slow considerably in 2006 when patents expire on some big drugs, including \$2.4 billion antidepressant Zoloft. Scala says he wouldn't be surprised if McKinnell did another deal ahead of those patent expirations to boost earnings. But with each successive deal, Pfizer's top line becomes larger—upping the need for new products.

It's true that scale brings some benefits. Larger companies can support bigger sales forces and afford to buy more consumer advertising—key drivers of revenue growth. And adding Pharmacia's sales force to its own

will transform Pfizer the largest drugmaker nearly every major market around the world.

But even on the same side, analysts warn that giants like Pfizer may garner little payoff from expanding their already swollen armies of sales reps. The top 40 drug companies have added more than 40,000 new U.S. salespeople over last decade, notes research firm Verispan Scott-Levin. "The number of doctors hasn't

risen as fast as the number of reps," says Barrie G. James, president of Pharma Strategy Consulting. "We are getting to the point of diminishing returns."

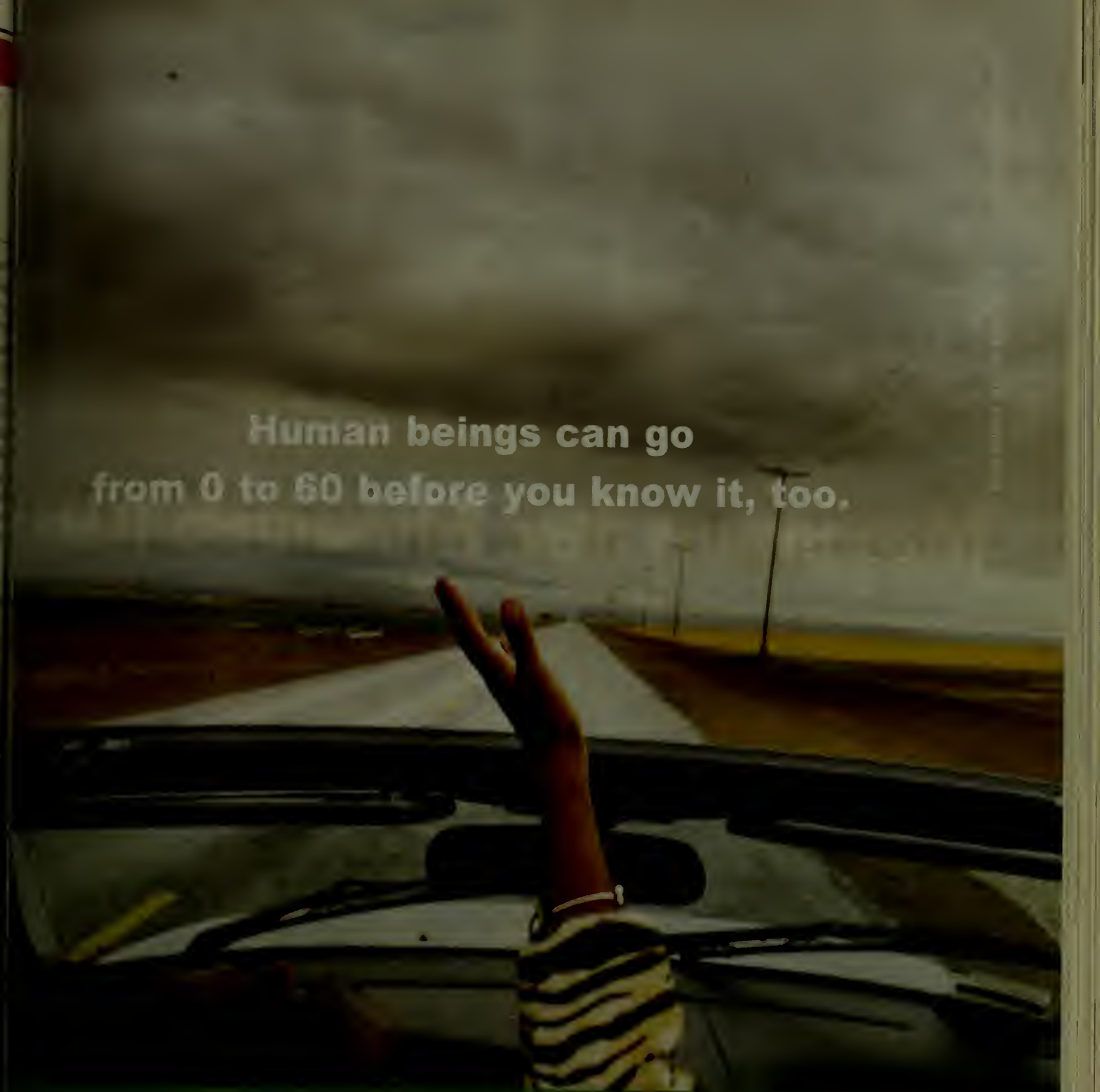
So if big mergers aren't the pick-me-up the industry requires, what can big drugmakers do to improve growth rates? Accenture's Blumberg says one important step may be to rethink the blockbuster business model. Many big companies tend to let small-to-midsize products languish with little management attention, focusing exclusively on the billion-dollar drugs. Blumberg argues that, with

pipelines so large, drugmakers can ill afford to let those products wither. Instead, he says, they need to focus more on maximizing the potential of such medicines by striking deals to outsource the marketing of those drugs, or licensing them to smaller outfits. That sort of innovation, not a wave

of megamergers, may be a better prescription for what ails the drug industry.

With Kerry Capell
London





Human beings can go
from 0 to 60 before you know it, too.

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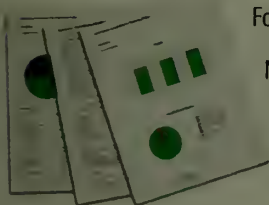
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COMMENTARY

By Tom Lowry and David Henry

IT'S NOT TIME
TO JETTISON AOL—YET

The mere mention of America Online in the corridors of AOL Time Warner Inc. these days is certain to stir up vitriol. The grand vision for the marriage of Old and New Media has been a bust for months, but disappointments in AOL continue to drag down all of AOL Time Warner.

Now, there's talk that one of the deal's most vocal salesmen, Chief Operating Officer and former AOLer Robert W. Pittman, may soon be leaving the company. For some, Pittman's departure could certainly serve as a rallying cry to jettison AOL, too. The company's cable, entertainment, and publishing businesses by themselves should be fetching around \$17 a share in today's stock market, based on shareholder and analyst estimates. But thanks to the cloud over AOL, the stock was worth \$13 on July 16, a 72% drop from when the merger closed 19 months ago.

So why not undo the deal and unleash the value of the old Time Warner? After all, the concept of media convergence is as discredited as former Vivendi Universal CEO Jean-Marie Messier, whose empire-building ended abruptly with his dismissal last month. Announcing a divorce would surely provide relief for Richard D. Parsons, the new AOL Time Warner chief executive who is nowadays spending countless hours trying to buck up dispirited employees and investors.

But is AOL the albatross it seems? Maybe not. It makes money. It helps sell *Time* and *People* magazine subscriptions and generates buzz for Warner Bros. movies, such as the coming sequel to the *Harry Potter* blockbuster. It also holds the promise of future profits if media content is one day delivered primarily via the Internet.

Perhaps more significant, there is no attractive way to cut AOL loose. The unit isn't going to fetch a

good price in today's market, a couple of bucks a share at best. Nor is it clear that investors would want shares in a newly orphaned business. "Time Warner got taken at the top by selling to AOL," says Gordon Hodge, analyst at Thomas Weisel Partners. "But selling AOL now would just be mis-timing things twice. They need to gut it out."

That won't be as hard as it looks, considering AOL's assets. AOL has 26 million U.S. subscribers, more than the next nine largest Internet service providers combined. Subscribers pay nearly \$6 billion a year in fees. Online advertising this year is expected to bring in \$1.8 billion in revenues even after plunging 31% from last year. After marketing, product development, depreciation, and other expenses, operating income should still be about \$1.5 billion from the U.S. If AOL were charged for, say, one-fourth of the corporation's total interest expense and corporate overhead—and even an extra \$100 million if it joined the new bandwagon and expensed stock options—it would still make nearly \$900 million this year in the U.S. before taxes. Compared with the company's cable systems, the AOL business requires little capital spending to keep going. Kiki Li, an analyst at SoundView



Technology Group, says the subsidiary still has "value," figuring worth at least \$4 a share.

All bets are off, of course, if reported numbers turn out to be wrong. AOL has a history of credibility problems with its financial reports, which itself is a drag on Time Warner's stock price. In 2000, the company agreed to pay a \$3.5 million fine to settle accusations by the Securities & Exchange Commission that it had capitalized marketing costs instead of counting expense against earnings. More recently, the reliability of its tally of 34.6 million worldwide AOL subscribers has been questioned. It counts free-trial subscribers in its numbers, pumping up apparent growth.

Parsons won't soon be done with jittery and restless investors, especially in these roiling markets.

True, AOL may not live up to the hype. But the CEO should be able to make the case that the Internet company is a keeper.

Lowry covers Time Warner, and Henry writes about finance, from New York.

WHY AOL
SHOULD STAY
IN THE FAMILY

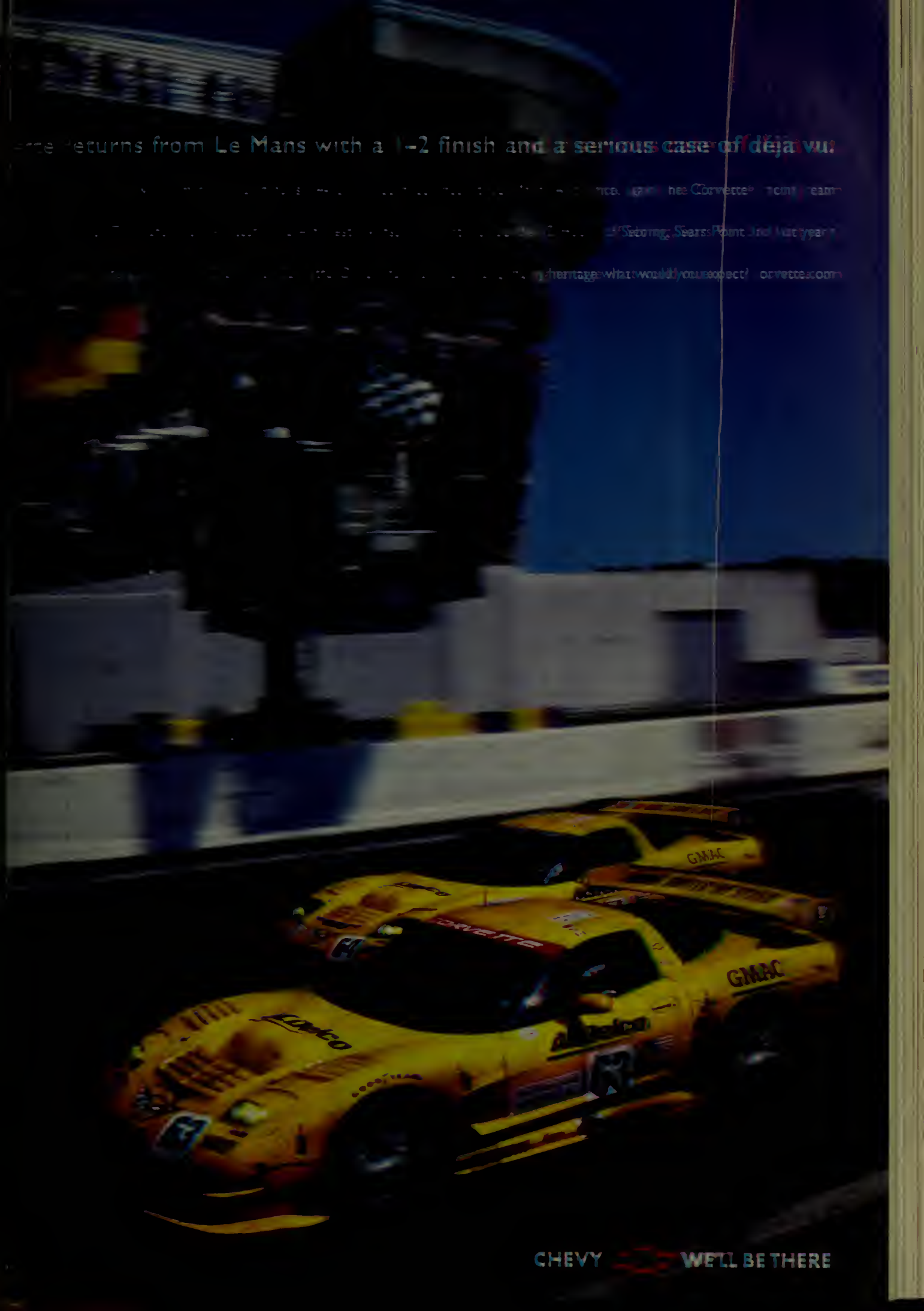
- It makes money. Operating income for 2002 is expected to be \$1.5 billion in the U.S.

- The world's largest ISP, with 34 million-plus subscribers, it would score big if Net ads recover.

- It would be a hard sell in the post-dot-com environment.

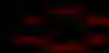
- AOL would allow Time Warner companies to cash in when the long-awaited broadband payoff finally arrives.

- Spinning off AOL would leave investors with another dot-com orphan.



Corvette Returns from Le Mans with a 1-2 finish and a serious case of déjà vu:

At Le Mans, the 1-2 finish was a historic moment for the Corvette team. The team's victory was a testament to the car's performance and the team's skill. The team's victory was a testament to the car's performance and the team's skill. The team's victory was a testament to the car's performance and the team's skill. corvette.com

CHEVY  WE'LL BE THERE

CORPORATE GOVERNANCE

IT'S GETTING TOUGH TO FILL A BOARDROOM

Jim Chapman is the kind of independent director who helps shareholders sleep at night. He's a professional corporate watchdog creditors bring in to serve on the boards of debt-laden companies. His most recent cases: Southwest Royalties Inc., a Midland, (Tex.)-based oil and gas provider and Davel Communications Inc., a Tampa-based pay phone operator. After doing this for seven years, he's getting nervous. As revelations of corporate misdeeds mount, regulators, legislators, and litigious investors are blaming directors for letting so much slip by.

The pressure keeps mounting: Starting from Aug. 14, chief executives and financial officers of almost 1,000 of the largest public companies will have to state under oath that their books are accurate. Although the onus is mostly on corporate execs, some directors are concerned they might also become more exposed. That's because books must first pass muster with the directors on their audit committees. Other new rules proposed by the New York Stock Exchange would require directors to meet regularly without management.

All this means much more work and potential personal liability for people like Chapman. His lawyer recently told him he should have his "head examined" for sitting on six boards. For now, Chapman has no plans to resign from any of them. But as lawsuits against board members pile up, he is reviewing his director and officer insurance policy. "It makes you think: Why would you ever want to be a director?" he says.

It's a treacherous new era. Until now, top executives and professionals gladly accepted prestigious directorships. "It was not too long ago that when you got an invitation from a CEO you said, 'Sounds terrific. It would be a pleasure to serve,'" says Michael A. Miles, the retired former chairman of Philip Morris Cos., who sits on the boards of Morgan Stanley, Dell Computer, and AOL Time Warner, among others. But with a rising threat of lawsuits or criminal prosecution if things go bad at a company, people are thinking twice before signing on. Says Miles: "Now you say, 'I'd like to consider it. Would it be all right if I spoke to a couple of other directors, the outside auditors, and your general counsel?'"

Some directors are even heading for the exits. Right now, a major concern of directors is the liability coverage they get through their companies. The trouble is most policies are void if the company commits fraud—leaving directors uninsured even if they had no role in the misbehavior. A May, 2002, McKinsey &

Co. survey of nearly 200 directors sit on almost 500 boards shows turned down a new offer or quit in the past year, at least in part for reasons. More than 80% of them say there is a "significant" threat of litigation and that it has increased in the past year. Says Robert F. Felton, a McKinsey director: "A lot more directors are saying 'I don't want to do this anymore.'"

The pressure could become even greater on chief executives: The boards want them to focus fully on their day jobs. Besides, say experts, there's a growing feeling that some people are "being advised not to join too many boards to be effective" and that they're "being advised not to make themselves too thin" and to make sure they're comfortable with any company on whose board they serve, says J. Sandler, a partner and co-head of the capital markets group at law firm Polk & Wardwell.

The comfort factor has never been more important. In the past, directors rarely faced serious consequences

BUT WHAT I REALLY DON'T WANT TO DO IS DIRECT

Independent members are getting a bad rap. They're not.

MORE EXPOSURE TO LITIGATION

Class actions against companies and directors have skyrocketed

INADEQUATE LIABILITY INSURANCE

Company coverage hasn't kept pace with increased risks, while individual policies are prohibitively expensive

INCREASED WORKLOAD

Proposed SEC and NYSE rules gives outside directors much more responsibility

failures. Now, the Securities & Exchange Commission is on a tear: In the first nine months of fiscal 2002, it has asked federal courts to bar 71 officers and directors from ever serving on a company board again, vs. 51 rebarred in 2001. And the AFL-CIO has asked the SEC to add Enron Corp.'s directors to the list.

One could blame potential directors for shying away. However, that leaves companies in a major bind: To satisfy new regulations, they need qualified financial experts to serve on audit committees. Some headhunters report a spike of as much as 25% in inquiries this year from companies seeking to replace insiders with independent directors. But few are biting. "It's more difficult than ever to find candidates because of the corporate governance environment," says Thomas J. Neff, U.S. chairman of the executive search firm Russell-Stuart.

One way to attract quality directors is to pay them more for the risks they're running. Outside directors of public companies on average earn about \$100,000 in cash and stock. That's up 75% since 1996, according to pay consultant Meyer & Partners. Still, if a director wants an individual insurance policy on top of the company's, it could cost as much as \$100,000 for up to \$2 million in coverage. "Currently, the expectations are going up faster than the compensation," says Charles D. Ellis, senior advisor to consulting firm Greenwich Associates.

Whether or not, Corporate America is going to have to make an increasingly less appealing job. "Most directors I know work extremely hard for their shareholders—far beyond what they are compensated [for]," says Daniel W. Dineen, a restructuring specialist at CIBC World Markets who sits on the board of Management Inc. Executives need only look at their stock prices to know what investors think. But they need good, aggressive lawyers to help restore their credibility in a seller's market.

*Emily Thornton and Louis Lavelle
New York*

VENTURE CAPITAL

THE VCS DON'T WANT YOUR MONEY ANYMORE

With the outlook bleak, they're returning clients' investments



Venture capitalists have a problem that most anyone would envy: too much money. During the boom times, VC funds, which finance startup companies, reaped staggering profits, and an embarrassment of riches from grateful investors.

What a difference a bear market makes. Now, most VC funds are underwater and quality investment pickings are slim. Foundations, pension funds, and endowments—the limited partners, or clients, of VC funds—are getting really edgy. What's more, nobody is in the mood to tie up money for the five years or more it takes typically for a high-risk venture to bear fruit.

That has set in motion an unprecedented retreat by the VCs. They are shrinking their billion-dollar funds, giving back money and forfeiting management fees. It's not that they're cutting refund checks, but rather releasing investors from their contractual commitments to fork over more money for fu-

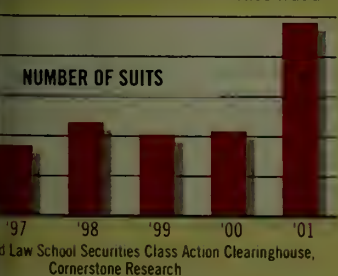
ture investments. "It's the moral equivalent of a refund check," says Kirk Walden, national director of venture-capital research at PricewaterhouseCoopers.

Through June, the givebacks have totaled at least \$3 billion. And that's a fraction of what's to come, observers say. In fact, VCs may end up returning about \$50 billion to investors in the next year. That's roughly equal to what the global venture community laid out in investments in the four years through 1998, before the floodgates broke in 2000 and a record-breaking \$105 billion was invested. Why are the VCs handing back cash that they normally scramble to attract? "The issue here is the return that you can expect to get on the money two years from now," says Robert C. Roeper, managing director of Boston VC Venture Investment Management Co. "It might just be negative."

Judging by VCs' recent performance,

SEE YOU IN COURT!

are bringing more class-action suits against
and their directors for securities fraud



"The issue here is the return you can expect two years from now . . . It might just be negative," says one VC

he could be right. When first-quarter performance figures are published before the end of July, they're expected to show losses. Last year, VC funds posted a collective loss of 28%—the first since 1970, when the numbers were first tracked. It's a blemish on an otherwise stellar record: The funds have earned 26.4% a year for the last decade and 18% a year since 1980.

Marquee names are leading the charge to hand back cash. Texas-based Austin Ventures Texas returned \$670 million from a \$1.5 billion fund in June. Charles River Ventures cut its latest \$1.2 billion fund by more than 60% just weeks earlier. They followed a slew of venerable Silicon Valley firms—Kleiner Perkins Caufield & Byers, Accel Partners, and Mohr, Davidow Ventures—that had cut their billion-dollar funds by up to 32%. Cutbacks at those three firms alone took a total of \$800 million out of the investment pool.

To be sure, the refunds aren't about altruism. A firm that gives back money now will likely have an easier time of raising more when the going gets good again. Meantime, they're forfeiting future fees—of about 2% a year on collected funds, plus a cut of any profits—they would have earned had they called in the money, though they're still getting paid for idle funds they have in hand. "We're walking away from several million dollars to make a statement that this business has way too much money," says Ted R. Dintersmith, general partner of the 32-year-old Charles River Ventures, whose clients include Notre Dame University, Hewlett-Packard, and Memorial Sloan-Kettering Cancer Center. "It's the right thing to do, but it's a painful thing to do."

Even with the downsizing, there's still too much money in the pipeline. In the first quarter—the most recent data available—VCs invested \$6 billion, equivalent to a more typical annual investment of \$25 billion. But there's still an \$80 billion overhang of uninvested capital from the 1999-2001 banner years. "There's enough money in the bank to last the industry for several more years," says Walden

of PricewaterhouseCoopers.

The VCs' conundrum is the lack of exit strategies. Even when they find entrepreneurs worthy of funding, VCs are no longer able to unload their upstarts quickly and reap easy profits. The stock market is sour on both initial public offerings and mergers, and the outlook is worsening: According to Thomson

Financial Venture Economics, VCs raised \$1.96 billion through IPOs and mergers and acquisitions in the first quarter this year—a 40% drop

their shares. Investors couldn't fast enough. "In the old days, you worry too much about the fundamentals of the business. The arrogant unbelievable," says Peter B. managing partner of New York City Venture Partners. "The raised a lot of money during the days, to put it bluntly, have not formed well."

As a result, VC funds are now less than their initial targets for the first time in memory. In June, for example, Murphree Venture Partners, a venture-capital firm based in Houston, closed its fifth fund at \$28 million below its \$100 million goal. Other scuttling their plans altogether. One Corp.'s private-equity arm has a \$200 million fund of funds, a lack of interest among high-worth clients.

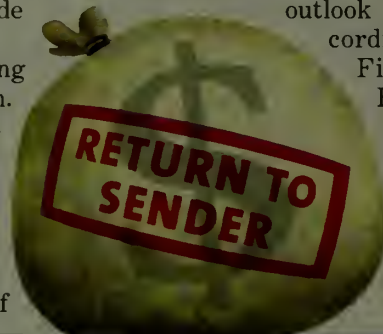
Although painful in the short term, the current shakeup will help the market, say fund managers. "Our portfolio companies are going to have to use less cash to improve profitability," says Robert P. B. who is chief operating officer of Atlas Venture in Waltham, Massachusetts. "We're adding some conservatism back into the model." Atlas, which has \$2.4 billion of committed capital, cut the size of its sixth fund, the Atlas Fund VI, by 12%, to \$200 million, in June.

New VC financing rounds are about half the size they were in boom times—from \$10 million to \$15 million for each startup. Seasoned entrepreneurs and twentysomethings are making

grade. "A year from now you'll see a stronger investing climate, and VCs will be more aggressive in competing for companies with a strong operational focus," Yunich says. "Innovation didn't stop just because the Nasdaq is down."

Venture capitalists, who kept champagne flowing during the dot-com bubble, are now nursing their hangover. They'll continue to attract trickle of money, even during tough times, because they're an important asset class to big pension funds and endowments. But to persuade investors to return in force, they'll have to come to grips with the lessons of the bust.

By Mara Der Hovav
in New



NOTHING VENTURED

VC funds are returning cash to backers because of a lack of good investment opportunities

	INITIAL FUND SIZE MILLIONS	AFTER GIVE BACKS MILLIONS
CHARLES RIVER VENTURES	\$1,200	\$450
AUSTIN VENTURES	1,500	850
ACCEL PARTNERS	1,400	950
WALDEN INTERNATIONAL	1,000	750
WORLDVIEW TECHNOLOGY PARTNERS	1,000	750
MERITECH CAPITAL PARTNERS	1,000	750
KLEINER PERKINS CAUFIELD & BYERS	627	470
MOHR, DAVIDOW VENTURES	840	650
ATLAS VENTURE	967	850

Data: Companies

from the final quarter of 2001.

The meteoric growth in assets during the bull market sowed the seeds of the VCs' current problems. Too much money chased a lot of bad business models. And those bad deals are still on the books. Dintersmith notes that few of the 300-odd private optical-networking companies that got financing have any hope of survival. "I don't think you're going to see 298 become successful," he says. "It's going to be a bloodbath."

Not so long ago, any entrepreneur with a half-baked idea could raise millions from VCs. Follow-on financing deals were a cinch. For a fast payoff, VCs pushed companies out assembly-line fashion to frenzied markets that bid up

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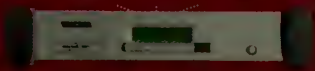
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A Special Report with

USA TODAY

Retirement: Avoiding



Panic Attack

B Y M I K E M c N A M E E

These are bleak times if you're thinking about retirement. With major stock indexes back to their 1998 levels, the gains of that heady boom—or was it a bubble?—have vanished. Executives who grabbed the brass ring while their portfolios were fat are brushing up on their consultant buzz words. The few workers who can stand to face their shrinking 401(k) balances are recalculating their retirement projections to grapple with new realities: later retirement, a part-time job after they accept the gold watch, stingier plans for travel, second homes, or leisure.

In this era of reduced expectations, *BusinessWeek* is here to help. We can't make the markets go up or the crisis of confidence in Corporate America go away. But our Annual Retirement Guide, produced this year in association with *USA Today*, can help you make the best of these harsher times—with advice on everything from adjusting your

retirement plans to withstand pay cuts to making the most of one asset that has shrugged off the bear market: your home. Whether you're looking for direction while you build up your 401(k) or figuring out a strategy to cash out, you'll find the expert tips you need.

The vast psychological gulf between yesteryear's bull market and today's reduced expectations shows up clearly in a new *BusinessWeek*/Harris Poll (chart, page 88). In a reprise of our 1998 retirement survey of high-income respondents 45 and up, we found that both current retirees and those thinking about it are feeling the pinch: Workers expect to be on the job longer, retirees are taking more part-time jobs, and they all expect to earn less from their portfolios.

The poll shows retirees are bearing the brunt of the market's fall. They're far less confident that their assets and earnings will support them in their golden years: 85% say they're somewhat or very confident, down from 95% in 1998. Little wonder, since 56% of retirees say their investments have lost nearly one-quarter of their value in the past two years.

While fewer retirees are working for post-retirement pay than in 1998, those with jobs are working harder. And they're more likely to say they're working because they need the money (37% give that reason now, vs. 25% in 1998). The bottom line: As market returns drop, Social Security and employment earnings loom larger in the income of retirees, accounting for 26%, up from 22% in 1998.

By contrast, today's workers portray a mix of re-

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As portfolios shrink, more workers are planning on delaying retirement. They're also rethinking travel, second homes, and leisure

alism and optimism in the BW/Harris Poll. Respondents admit they're likely to stay on the job longer: Their average expected retirement age rose to 65 this year, up from 63 years and 1 month in the 1998 poll. (That's higher than the age at which current retirees say they quit—an average of 54 years and 6 months.) Today's workers see a stock crash as the second-largest threat to their retirement security, trailing only catastrophic medical expenses.

And, like retirees, workers report much reduced hopes for what their investments will earn. Their expectation for long-term stock returns fell from 16% a year in 1998 to a more realistic (but perhaps still unachievable) 11% in the latest survey.

Yet today's workers are still upbeat. There's no real change in the share of workers who say they're somewhat or very confident that their benefits, savings, and work will support them throughout retirement. In sharp contrast to current retirees, fewer of today's workers think they'll be working for pay after retirement (65% predict that now, vs. 75% in 1998). About one-third say they'll work in retirement because they'll need the money, down from 43% in 1998.

Are today's workers deluding themselves? Unfortunately, there's plenty of evidence that too many investors are caught like deer in the headlights—of a market that's thundering south (table). For the first two years of the markets' tumble, most 401(k) participants sat on the sidelines, according to data from plan manager Hewitt Associates. "People just don't know what

LOWER EXPECTATIONS...LESS MONEY

Workers' expectations for investment returns have fallen sharply since 1998, according to the BW/Harris Poll. In 1998, workers expected a balanced portfolio to return 13.88% a year; in 2002, they expected only 10.05%. For workers who start out with \$100,000 in a 401(k) and contribute 10% of their salary each year**, that difference in return amounts to more than \$1 million after 20 years.*



to do," says Lori Lucas, a pension coach at Hewitt.

As a result, many employees are letting 401(k)s bounce about in today's volatile market rather than actively managing the allocation of assets in the accounts. Take the share of workers invested in stocks: It rose with the market to 74% in late 2000, only to fall to 65% now. For most workers, having three-quarters of their assets in stocks was probably too high. In addition, more, a worker who had maintained today's stock allocation during the boom—by not enough appreciated stocks to keep the portfolio in line—could have avoided thousands of dollars in losses.

Most worrisome: Even after the collapse of Enron and its 401(k) plan, workers are still dangerously overexposed to employer stock. About three-quarters or more of account value is up three-quarters or more of account value. 29% of the 401(k) accounts Hewitt manages are in employer stock, and that figure rose to 33% for employees age 60 or older.

Not all investors are paralyzed. Web site manager at Diversified Investment Advisors manages \$50 billion in pension and 401(k) assets. It was 65% higher in 2002's second quarter than in the same period last year, according to

WHAT A DIFFERENCE A BEAR MARKET MAKES

The bear market has slashed the portfolios of workers and retirees alike—but it's retirees who are bearing the brunt. To gauge the market's impact, BusinessWeek asked Harris Interactive Inc. to repeat our 1998 survey on attitudes about retirement and investing among affluent adults—1,022 respondents 45 and older with incomes of \$85,000 or more. The 1998 poll was conducted in late June, when the Standard & Poor's 500-stock index was coming off a 3½-year, 150% climb; the 2002 poll was done between June 28 and July 2, with the S&P 500 down nearly 40% in the previous 2 years. Selected findings:

MOST ADULTS SAY THEY'RE HURTING.

In the last two years, has the value of your savings for retirement...

	RETIREES	WORKERS
Increased	30%	33%
Decreased	56	50
Remained the same	14	16

HOW MUCH?

	RETIREES	WORKERS
For those with increases	+19%	+15%
For those with decreases	-25	-26

RETIREES ARE FEELING NERVOUS

How confident are you that you have enough income to retire on?

Very confident	19
Somewhat confident	62
Somewhat worried	33
Very worried	9

SO THEY'RE WORKING HARDER

Among retirees who work, the percentage saying their retirement earnings they're earning is:

1998	19
2002	62

vice-president at the firm. Financial planners report that it's easier to convince clients of the benefits of diversifying their portfolios and to lower projected rates of return. "From '95 I ran a projection that only had 10% return on equities, the client would say: 'Get better investment,'" says Ian Bishop, a adviser at American Express Financial Services in Upland, Calif. (While stocks returned 2.2% from 1946 to 1997—7.5% after inflation—many market pros predict returns will be 2 points lower over the next 20 years or more. Reason: They don't think stock prices will continue to grow 2.5 times as fast as corporations.)

Of course, you want to be among the awake and to take the necessary steps to grow your portfolio, your expectations, or both. **Started.** Think hard about what you want for retirement. New research from mutual-fund company AIG SunAmerica shows that today's happiest retirees aren't living out a dream of leisure. They're the seniors who work part-time and stay engaged in their communities. These "ageless explorers" are "the people who've thought and planned the longest for their retirement—they're prepared mentally and psychologically, as well as financially," says Jay Wintrob, CEO of AIG SunAmerica. If you wait until you're 55 to start thinking about retirement, you may not have time to develop a second career, make contacts in part-time consulting business, or get active in community affairs.

Help. More employers are offering 401(k) plans—usually a mix of online and telephone advice. Workers who are motivated enough to take their retirement outlook usually end up saving their savings substantially—from 6% to 10%—says Christopher Jones, a vice-president at Financial Engines, which offers such advice. If you need a push to get moving or are overwhelmed with \$200,000-plus in assets, personal advice from a financial planner may be worth the expense.

■ **Expand your Horizons.** Even after the hammering that stocks have taken, most investment pros think long-term investors still need to be heavily weighted in stocks. "Equities are at bargain prices," argues Roy Kormack, owner of Family Financial Architects, an advisory firm in Natick, Mass. But investors will need to look beyond the Dow Jones industrial average and the Standard & Poor's 500-stock index. Small- and mid-cap stocks are outperforming the large-cap darlings of the '90s, and bonds have the potential to deliver good returns at far less risk over the next decade or two.

■ **Mind the Basics.** Whatever your asset mix, it's not working if you let it drift along with the market. Schedule reviews once a year,

at a minimum, for your portfolio. Rebalancing—selling investments that have risen to lock in gains and buy cheaper assets—adds precious percentage points to your return. And when gains are smaller, you can't be sloppy about monitoring such investment expenses as commissions and mutual-fund fees. For a \$100,000 mutual-fund portfolio with a gross return of 11%, the difference between a 1.5% expense ratio and a 0.5% charge over 20 years is \$122,460—not small change.

After the beating they've taken, investors may feel like small change is what they're scrounging for. You can't do anything to turn the market around. But you can take steps to plan your retirement and position your portfolio so that your dreams and your means will intersect. In an era of reduced expectations, it's up to you to make the best of your plans.

RETIREMENT GUIDE

401(k)s : GOING NOWHERE

As account balances shrink...

AVERAGE ASSETS PER 401(K) PARTICIPANT AT YEAREND

1999	\$45,681
2000	\$40,918
2001	\$36,390

Data: Cerulli Associates

... Savers seem frozen and unable to adjust...

► Only 19.5% of plan participants adjusted their investment mix in 2001 (down from 30% in 2000)

► 401(k) investors are drifting with the market: Stocks' share of 401(k) assets has fallen to 65% (down from 74% in 2000), making accounts more conservative

► But savers are still over-exposed to their employers' stock: 29% have three-quarters or more of their funds in company stock

Data: Hewitt Associates

BusinessWeek online

For the complete results of the retirement poll and more, go to the July 29 issue at www.businessweek.com

NEED THE MONEY.

Retirees who have continued

	1998	2002
Money.....	25%	37%
Challenged		
ted.....	92	83
y close to		
associates.....	13	9
allowed		

WANT TO RETIRE LATER...

Do you plan to retire?	
.....	63.1 years
.....	65.0 years

BUT DON'T THINK THEY'LL NEED TO WORK...

What are your employment expectations after retiring?

	1998	2002
Do not expect to work for pay...	25%	35%
Continue working in my current occupation, at reduced hours and pay.....	15	20
Work full-time in a different occupation.....	2	2
Work part-time in a different occupation.....	28	20
Consult within my current industry.....	19	16
Start a new business.....	10	6

EVEN THOUGH THEY'RE EXPECTING LESS FROM THEIR INVESTMENTS.

What annual rate of return do you expect from your investment in:

	1998	2002
Investment real estate.....	13%	15%
Bonds.....	13	8
Stocks.....	16	11
Mutual funds.....	15	11
Money-market funds.....	10	7

Data: BusinessWeek/Harris Poll

Results are based on a survey of 1,022 adults aged 45 or over with incomes of \$85,000 or more. Of the respondents, 312 are retired. Interviews conducted online between June 28 and July 2, 2002



Green at home with her son: "In this type of market, I don't know what to do"

Where Should You Turn?

Here's how to get advice for your 401(k)

BY SANDRA BLOCK/USA TODAY AND LEWIS BRAHAM/BUSINESSWEEK

Maggie Green, a computer software specialist in Oklahoma City, has a 401(k) plan that many workers would envy. It offers at least 15 investment options, ranging from aggressive stock mutual funds to low-risk bond funds. But Green, 44, says she's confounded by the choices. "In this type of market, I don't know what to do," she says. After watching the bear market consume a big chunk of her savings, she would like more individual attention—a financial adviser who will examine her portfolio and tell her "where I am and where I want to be."

There's help for bewildered investors like Green, some free and some that costs thousands. Before you do anything, think about what you want from an adviser. No one's going to recover a 50% drop in your account overnight. If all you need is to retool your asset allocation and choose different funds, there's a lot of help at Web sites such as ClearFuture.com or mPower.com (table).

You probably need a flesh-and-blood adviser when things get more complicated. If your plan matches all of your contributions in shares of company stock, if your 401(k) makes up the bulk of your savings, or if your plan has too many investment options or too few, an adviser can help.

Perhaps the best reason to seek advice is the fear factor. "Some investors are so scared when they lose money, they pull out of the stock market altogether and stop contributing to their 401(k) plan," says Gary Schatsky, a New York financial planner. "That's the worst thing you can do." An adviser can hold your hand through the rough times—and help you let go of the dogs in your portfolio. "If your investment has lost 40%, it's already lost," says Michael Scarborough, an Annapolis (Md.) financial adviser. "The only thing you can think of is: 'From today forward, how can I make money and limit my volatility?'"

What if your plan has only three mutual funds,

and all of them are dogs? An adviser may develop a "holistic" asset allocation plan, which incorporates investments outside your 401(k) to compensate for its weaknesses. For instance, some companies allow for an "in-service withdrawal" that allows employees to move as much as 50% of their assets into an individual retirement account, which will have a better selection of funds.

If such a withdrawal is not available, an adviser can use nonretirement assets as a hedge. Schatsky will often invest the majority of a client's assets in her 401(k)'s bond fund, which typically has lower expenses than the other plan funds and pays income that would be taxed outside of a 401(k). In taxable accounts he buys equity funds that have better track records and lower expenses than the plan funds.

Another common problem arises with employees owning too much company stock. An adviser will usually limit the company-stock allocation to no more than 10% of assets. But some companies match employee 401(k) contributions

with company stock and force them to hold the shares till retirement. "Buying company stock is the best option in these tough situations," says Scarborough. A put option is a financial contract that acts as a hedge against a decline in stock's value. If the stock falls, the put option's value rises.

Finding an adviser takes work. Some, such as Charles Schwab and Fidelity Brokerage Services

offer a free one-time portfolio review, and for some people, that may be enough. A tailored financial plan will cost you upwards of \$1,000. If you want someone to manage your portfolio, Web sites can locate advisers in your neighborhood. Some don't charge fees but take commissions on the investments they sell you. More advisers, however, are going the fee-for-service route, charging 1% or more of your assets annually. Advice isn't cheap—but in a bear market, it may be your best investment.

**RETIRED
GUIDE**

FINDING ANSWERS

WEB SITE (WWW.) / COMMENTS

CLEARFUTURE.COM Analyzes your risk tolerance and 401(k) portfolio allocation and recommends funds.

FPLANET.ORG/PLANNERSEARCH Finds a certified financial planner in your neighborhood.

INVESTORTREE.COM IntelligentMatch system helps you find a planner who meets your specific needs.

MPOWER.COM Analyzes risk tolerance and portfolio allocations for all of your assets.

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Playing Catch-up When Your Salary Stalls

Gauge the impact on your nest egg, then save more

BY ANNE TERGESEN

The bear market has inflicted enough pain on retirement savings. But if you're among those whose salaries have stagnated, declined, or failed to keep pace with expectations this year, your retirement plan may be even further from your goals. Since salary levels play a key role in retirement payouts, you may have to "save more and work longer" to compensate for these lean years, says Olivia Mitchell, a professor at the University of Pennsylvania's Wharton School.

So you didn't get a 3% raise this year. This may seem like no big deal, but because of the power of compounding, losing even a small salary

hike can produce big differences in benefit year, salary shortfalls are sure to be painful, since most people won't be able to make up for lost ground in the stock market.

Consider a 45-year-old man whose salary remains at \$150,000 this year, instead of rising to \$154,500. At 65, his 401(k) will hold less, assuming he saves 10% of his salary each year and earns an annual return of 7%, according to Jack VanDerhei, a professor at Temple University's Fox School of Business & Management. If he has a traditional pension plan with company contributions, the salary freeze will hurt his future benefits by almost \$3,000 assuming he works for 20 years and the plan pays 40% of his preretirement earnings.

Whether your salary falls or simply doesn't keep up with expectations, it's impossible to gauge the impact on your retirement nest egg. That way, you can take steps to recoup.

Luckily, tax laws that went into effect in 2006 make it easier to play catch-up with 401(k)s, the maximum pretax contribution limit rose to \$15,000 in 2006. Those over 50 can contribute an extra \$1,000 now, and that rises to \$1,500 in 2006. And most plans allow after-tax contributions once you've hit your limit. Defined-pension plans offer no way to recover lost benefits because of stingier-than-expected pay. Still, you can compensate by increasing other savings.

With 401(k)s, it's relatively easy to figure out how to make up for a salary shortfall. First, compare what you expected to earn this year with what you are actually getting. The 45-year-old making \$150,000 is being paid \$4,500 less than he expected. Then, calculate how much he is contributing to your 401(k) as a percentage of salary. If the man puts 10% of his pay into a 401(k) each year, his contribution will be \$450 less than he would've been had his pay risen. To make up for that deficit, he can increase his contribution.

For traditional pensions, the catch-up involves more guesswork. To find the formula for calculating benefits, consult your employer's benefits department or "summary plan description." Most plans use years of service, salary, and a specified percentage. Take a woman who stays with a company for 20 years. If the company formula's percentage is 2%, she will receive 40% of her final pay in retirement (20 years times 2% equals 40%).

When determining what salary to plug into the formula, most plans use an average of the employee's highest five years. So, to figure out how a lower pay affects benefits, it's necessary to estimate future pay raises. Since this is difficult, you might fall back on a simple rule: For most retirement payouts rest on an employee's highest salary, don't worry if you are far from retirement—you have time to make up for pay falls. But if you are close to retiring, crunch the numbers, funnel catch-up cash into another investment vehicle, and hope your company is among those forecasting salary increases of 4% for 2006.

HOW PAY FREEZES CAN COOL RETIREMENT SAVINGS

Suppose a 45-year-old earns \$150,000 a year, expects 3% annual salary increases, and puts away 10% of the income in a pretax and after-tax 401(k) plan in which the average annual return will be 7.5%. What's the impact of a pay freeze at age 45?

AGE	VALUE OF 401(k)	
	WITHOUT FREEZE	WITH FREEZE
55	\$277,125	\$269,953
60	525,362	511,353
65	902,048	877,631

Data: Jack VanDerhei, professor at Temple University's Fox School of Business & Management

Peace-of-Mind Portfolios

Life-cycle funds shift your asset mix as you age

BY SUSAN SCHERREIK

Life-cycle funds, which offer investors pre-mixed portfolios of stocks, bonds, and cash according to their age, have been around for about a decade. The diversified approach they take is a smart way to save for retirement, but you'll rarely hear a financial planner or broker recommend them. "They wouldn't be good for business," confides Dee Lee, a Boston financial planner and co-author of *The Complete Idiot's Guide to Retiring Early* (Alpha Press, \$19.95).

Why? These mutual funds make practically all the investment decisions for you. They're designed to get you from an aggressive stock-heavy portfolio to a more conservative investment mix the closer you get to retiring. Once you retire, they're also a handy way to stay invested partially in stocks while drawing a steady income from bonds and cash.

At a time when the stock market is sagging, the strategy of these funds looks wise. Over the past five years through June 30, the typical life-cycle fund has gained an annualized 4.20%, vs. 3.89% for the average stock fund, according to investment-research firm Morningstar. This year, life-cycle funds are off 6.42%, but that's a better showing than the 11.70% loss racked up by the average stock fund.

Life-cycle funds operate in one of two ways. The first type is a fund with a targeted retirement date. If you invest in Fidelity Freedom 2030, for example, 84% of your money will currently be in large-, medium-, and small-company stocks, including nearly 9% in international equities. Over the next 28 years, the mix will move toward more bonds and cash.

The second and more common life-cycle investment is a series of funds with preset asset allocations. It's not as hands-off as the first type: You must move the money from one fund to another, perhaps once a decade, to ensure that you

have the right portfolio for your age. An example: Vanguard's LifeStrategy series, which goes from growth to moderate growth to conservative growth and finally, income.

Although Charles Schwab and other financial supermarkets offer life-cycle funds to individual investors, 401(k) plans are their biggest market. But Lucas, a defined-contribution consultant at employee-benefits firm Hewitt Associates, says many workers don't use them properly. They put equal amounts in a life-cycle fund, a money market fund, and maybe a bond fund, so all told, they're overloaded with too many investments.

You should use a life-cycle fund as the core of your portfolio, holding and adding other funds to diversify your overall portfolio. For instance, Vanguard's LifeStrategy Growth keeps only 5.9% of its assets in small-company stocks. So

if you own that fund, you might also want to own a small-cap fund. Fidelity Freedom 2000 (for investors who are about to retire, or just did) keeps 40% of its assets in assorted large-, medium-, and small-cap stocks. But financial planner Lee advises that retirees hold closer to 40% of their investments in equities. In that case, you also want to own a broad stock fund, such as the Wilshire 5000 stock index fund, that invests in the Wilshire 5000 stock index.

Many life-cycle funds are "funds of funds," meaning they're comprised of various stock and bond funds. This means you really have to watch the fees. Franklin Templeton's Conservative Target A, for instance, charges an annual expense ratio of 0.54%, calculated from the 12 individual funds it owns, as well as its own 0.92% on top. An exception: With Vanguard, you pay the fee for the underlying funds, but the fee for managing the mix.

A life-cycle fund will never be the hottest fund of the year. But with life-cycle funds, you have to know when to get out. With life-cycle funds, you can just dump them right into retirement.

Over the past five years, these funds have beaten the average stock fund. For 2002, they're down only half as much

RETIREMENT GUIDE

A SAMPLING OF LIFE-CYCLE FUNDS

FUND/SYMBOL	TOTAL RETURN*		
	1-YEAR	3-YEAR	5-YEAR
FIDELITY FREEDOM 2020 FFFDX	-12.17%	-2.68%	5.68%
SCHWAB MARKETTRACK CONSERVATIVE SWCGX	-2.45	1.94	5.28
SCUDDER TARGET 2010 KRFAX	-0.14	3.04	7.31
VANGUARD LIFESTRATEGY CONSERVATIVE GROWTH VSCGX	-2.90	1.26	5.97

*Appreciation plus reinvestment of dividends and capital gains before taxes. Returns are through June 28. Multiyear returns are annualized.

Data: Morningstar Inc.

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He can't talk, he can't walk, he can't drive a car. Yet he could be the most important "person" in the world of automotive safety testing today. He's THUMS, the world's first virtual human for crash testing.

Developed by Toyota engineers, THUMS can provide a microscopic look at the injuries real people are likely to sustain in a car accident. By analyzing data from THUMS' 80,000 cyberparts, engineers can now zero in on skin, bones, ligaments and tendons—something they were never able to do before.

Although currently only an experiment, technologies like THUMS may one day be used to supplement Toyota's existing safety programs, to make our cars even safer for real human beings. Safer cars—thanks to one very smart dummy.

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Selling their suburban home netted Rubenstein and Bassi \$350,000 tax-free

Stock Shocked? Your House Can Help

Lock in gains now from the hot real estate market

BY SUSAN SCHERREIK

Herb Rubenstein and Laurie Bassi are in their late 40s and won't retire for years. The couple also has no interest in leaving the Washington (D.C.) area anytime soon. Yet Rubenstein, an attorney, and Bassi, an economist and investment consultant, rushed to sell the five-bedroom house in Chevy Chase, Md., where they raised two children as soon as their youngest graduated from high school in June. The house, which the couple bought nine years ago for \$500,000, fetched around \$850,000. "The hot real estate market had a lot to do with our

decision," says Rubenstein. So did a federal tax act passed in 1997, that let married homeowners skip taxes on gains of \$500,000 (\$250,000 for single owners) when they sell a primary residence. Homeowners can take that exemption as often as they like—as long as they've lived in a house for at least one year in the most recent five years. Rubenstein and Bassi moved to a three-story house in Washington the year they were married but had rented before when they moved to the suburbs. Their long-term plan is to retire to San Diego or Boulder, Colo. They plan to use the bulk of their home sale profits in the stock market.

At a time when home prices continue to rise while the stock market leads, investors are turning to real estate holdings in a variety of creative ways to help them bolster retirement savings. In some cases, empty-nesters such as Rubenstein and Bassi who are downsizing so they can reap tax-free profits on the sale of their family home. In other cases, they're people in their 40s who are taking advantage of low mortgage rates to buy a second home in a desirable vacation spot and rent it out until they retire.

Meanwhile, a popular strategy for the recently retired to finance a home purchase is even if they have cash on hand. The appeal: You can shave your tax bill with mortgage-interest deductions while using your cash for living expenses. That way

you can delay withdrawing from tax-deferred retirement accounts when stock investments plunged to their lowest levels in years. Of course, this plan works only if you believe future gains will outweigh mortgage costs.

Financial planners say one of the smartest things homeowners approaching retirement do is to decamp to a smaller house or "In today's red-hot real estate market, you shouldn't hesitate" to lock in profits before the bubble bursts, says Christopher Cordaro, a Chatham (N.J.) financial planner.

Cordaro urged a recently retired client and his wife, who are having a home built in San Francisco, N.M., to sell their New Jersey house in

rather than wait until the new house is completed several months from now. The couple can rent an apartment until the new home is ready. "It's risky to own two homes if your goal is to get down to one," Cordaro says. "If the market falls, you could have problems selling." Another reason to trade down is that Uncle Sam allows you to keep more, if not all, of your profit. Before the 1997 tax-law change, homeowners, married or single, were allowed a one-time exemption of \$125,000 from the sale of their residence, and only if the owner (or one spouse) was at least 55. Homeowners of any age were also allowed to roll over profits from a home sale into a new house of equal or greater value as often as they liked. Years ago, that tax-free rollover was eliminated and the repeatable \$500,000 exemption went into play.

It needn't be an empty-nester to take advantage of the new rules. Michael Beriss, a financial adviser for American Express in Bethesda, has a 45-year-old client who inherited a house when her mother died. Initially, the client lived on renting out her own home while she moved into her mother's house and renovated it. But Beriss advised her to sell her home to obtain the tax-free profit, live in her mother's home for two years, and repeat the process.

Caveat: Your tax-free profit might be lower than you expected. That's because any profits from before 1997 and rolled into subsequent home purchases must be added to your gain. For example, say you bought a house in 1996 for \$200,000, paying for it in part by rolling over the \$100,000 profit from the home you sold. Today, your house is worth \$1 million, so you'll have \$500,000 on the sale. In the eyes of the Internal Revenue Service, your profit is \$600,000, so you'll have to pay taxes on \$400,000, says David Rhine, chief director of family financial planning at Sagemark in New York City.

But if you want to exploit your real estate holdings, you Stanasolovich, a financial planner in New York City, says a common strategy for homeowners who are buying a third residence is to finance the property with home-equity loans tied to their first two homes. The reason: You are allowed to deduct mortgage interest on the two properties you own. But you can write off interest on home-equity loans of up to \$100,000 on both residences, says Rhine. Another way to tap your home equity is to refinance your mortgage. To qualify for tax-deductible interest, you can refinance up to the remaining amount of the mortgage, plus \$100,000. However, your home loans can't exceed the

property's value in order for the interest to be tax-deductible.

Home-equity loans can also provide the needed cash to help finance a retirement-home purchase—as long as you plan on moving within two to three years. Robert Reby, a Danbury (Conn.) financial planner, says a client and his wife are building a retirement home in South Carolina, but they don't want to move or sell their New York home for two more years. So instead of taking out a construction loan that can carry fees of several thousand dollars and require lots of paperwork, the couple got a home-equity loan. "It's a temporary, low-risk strategy," he says.

The danger, of course, is that rates will rise—which means the variable-rate home-equity loan will become more costly. That's why Reby says this strategy is best when used to cover a relatively short period.

A popular strategy for people in their 30s and 40s is to buy a home in a desirable retirement community and rent it out. That's what Rayetta and Steve McCuiston, both 43, are doing. The Chicago couple bought a Sanibel Island (Fla.) condominium five years ago for \$260,000 and sold it nearly two years later for \$100,000 more than they paid for it. The McCuistons then upgraded to a \$410,000 Gulf-front condo, which brings in about \$33,000 a year in rental income. That covers nearly all of the carrying costs, Rayetta says.

Rayetta, a corporate trainer, says she believes her condominium will continue to increase in value because the verdant island strictly limits its development. And with baby boomers set to

RETIREMENT GUIDE

HOW TO TAP YOUR REAL ESTATE

- ▶ Sell the big house now and downsize to take advantage of tax-free gains of up to \$500,000
- ▶ Take out a mortgage even if you can afford to pay cash for a home so you can postpone withdrawals from your IRA or 401(k)
- ▶ Buy a retirement home in a hot vacation spot years before retirement and rent it out to help pay for it
- ▶ If you're buying a third home, take out home-equity loans on your primary residence and vacation house to fund the purchase, since mortgage interest on a third dwelling isn't tax-deductible

retire en masse over the next two decades, Rayetta thinks she and her husband would have been priced out of the market if they had waited. "Our condo isn't our ultimate retirement home, but when we do retire to Sanibel Island, we'll sell it and use the proceeds to get the home we really want there," Rayetta says. In the meantime, the McCuistons use the condo for off-season vacations with their two teenage children.

For most people, their house is their biggest asset. With stocks sinking and bond yields low, it might also be their best tool for shoring up retirement plans. ■

**Married
homeowners
owe no tax on
gains of up to
\$500,000 when
selling a
primary abode.
And as long as
they live in
their next
house 2 years,
they can use
the exemption
again**

Should You Take a Lump Sum?

IRA vs. annuity: A tricky choice when you retire



BY SANDRA BLOCK

Retiring was easy when most workers were covered by traditional pensions: You cleaned off your desk, bade farewell to colleagues, and waited for your monthly check to roll in. But as more companies have shifted to 401(k) plans and portable pensions called cash-balance plans, retiring workers face some difficult choices. Should they empty the pot, roll the contents into an individual retirement account, and try to manage their way to a reasonable rate of return? Or should they convert the money into an annuity—either through their employer or an outside insurer—that guarantees a monthly payment for as long as they live?

Pension experts believe the bear market, which has eviscerated many workers' portfolios, may compel more retirees to choose the security blanket an annuity provides. Most Americans aren't very good at budgeting or making investment decisions, says Norman Stein, a pension expert and law professor at the University of Alabama. "The consequences of mis-

managing your money can be disastrous,"

In exchange for that security, you get control. By putting your savings in an individual retirement account, you determine how the money is invested, and you can withdraw as much as your needs dictate. In the meantime, your investments continue to grow. You'll have to take minimum annual distributions once you turn 59½, but new tax rules have sharply reduced the withdrawal amount.

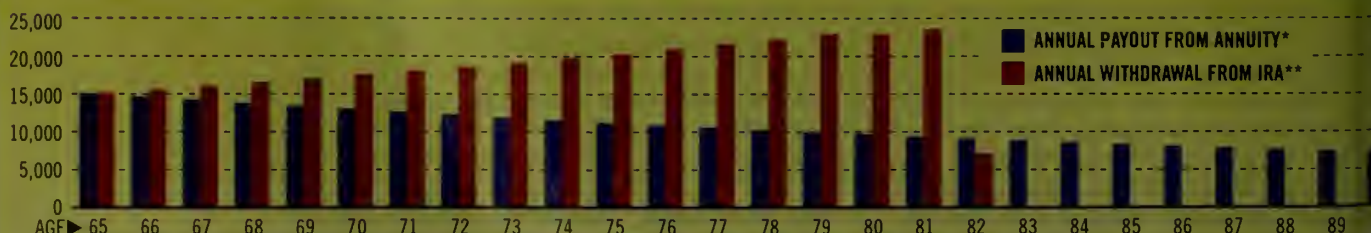
The control issue is of enough concern

that about 90% of retirees take the annuity option and 401(k) payouts in a lump sum, then transfer it to an IRA, says Rich Koski, director of research at Buck Consultants. Of course,

you could run out of money, particularly if the market heads south when you start taking distributions (table). Still, many retirees like the ability to take annual or monthly withdrawals from IRAs based on estimated living expenses, rather than to withdraw larger amounts for emergencies. With an annuity, you don't have that flexibility. Without another source of cash, you may not be able to cover expenses that arise when t

RETIREMENT GUIDE

FIGURING THE PRICE OF SECURITY



▲ DOLLARS

Data: T. Rowe Price Associates

*BASED ON AN ASSUMED INTEREST RATE OF 6%, WHICH RESULTS IN A 7.58% ANNUAL PAYOUT, ADJUSTED FOR INFLATION

**BASED ON A RETURN OF 6%, WITH AN ANNUAL WITHDRAWALS OF 7.58%, ADJUSTED FOR INFLATION

***PAYMENTS WILL CONTINUE AT THIS LEVEL FOR THE REST OF YOUR LIFE



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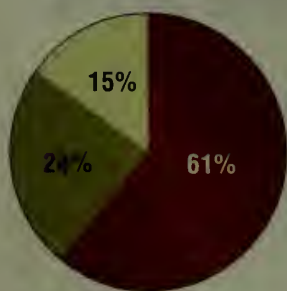
Q. What do seven out of ten American workers say will motivate them to perform better on the job?

A. A good benefits plan.

According to the 2nd Quarter 2002 Principal Financial Well-Being IndexSM, 70% of today's workers say a good benefits plan inspires them to work harder and perform better at work. And 61% say an attractive benefits program would encourage them to stay with their employer.

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- Agree/somewhat agree
- Disagree/somewhat disagree
- Neither agree nor disagree

Source: 2nd Quarter 2002 Principal Financial Well-Being IndexSM

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BusinessWeek Investor

nance quits or the car breaks down. "The argument for a guaranteed income is very compelling, but it's too restrictive," says Linda Lubitz, a financial planner in Miami. "Life is guaranteed to change."

What's sure to change as you age is your health—and this may make an IRA more attractive. If you have an illness, an IRA lets you withdraw for medical costs not covered by your insurance. Lifetime income guarantees, on the

live longer, they receive lower payments by insurer calculated

You can shop for higher payouts side your company. But remember: Fees and commissions reduce

your net payout, says

sultants' Koski. If

that you can indicate

your monthly payments

buying the annuity

first roll your savings

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your savings. Once

they are safely in an

to purchase an annuity

There is a way to

guaranteed monthly

without locking your

Annuitize your

One advantage of an IRA is that it allows you to take out large sums when necessary for health care

other hand, aren't as valuable if you don't expect to live long. If you convert to an annuity with a lifetime payout and make it to 105, you win. But if you die within a few years after annuitizing, the insurer wins, and your survivors and heirs lose. The exception: an annuity that makes payments to your spouse or heirs after you die. But you get a smaller payout while you're alive. By contrast, what you don't spend in your IRA, you can leave to your spouse or heirs, who'll have to pay taxes only on withdrawals for funds under \$1 million. Your heirs, other than a spouse, will face estate taxes on funds \$1 million or over.

If you still prefer an annuity, your employer could help you set it up. Companies with cash balance plans usually offer an immediate-annuity option, and some will also annuitize your 401(k). The payment amount will depend on your initial investment, the estimated return, and your life expectancy. The estimated return is based on an assumed interest rate. Company pension administrators usually use the 30-year Treasury bond, which now yields 5.4%.

When deciding between accepting your employer's annuity plan or buying one yourself, keep a few things in mind. Women usually fare better in taking their company's annuity, says Towers Perrin's Bill Daniels. By law, employers must calculate payments based on the average life expectancy of both men and women. Insurance companies use separate mortality tables for each gender. Because women tend to

sponsored retirement plan and other savings, such as a Roth IRA, are able investment portfolios for discretionary expenses. If a money is in your employer's plan, you can annuitize part of it, leaving the rest out to invest in an individual

Increasingly, companies are offering this option, Lubitz says. If your employer

won't let you annuitize some savings, you can take the lump sum, roll it into an IRA, and annuitize your savings within the IRA.

Up some of the advantages of your employer's annuity, which may offer

payments at a lower cost. The flexibility could be worth it.

To minimize the bite of commission fees, consider annuitizing by such no-load funds

as TIAA-CREF, Fidelity Investments, or T. Rowe

Group. Compare

www.immunity.com.

Some annuities pay your heirs if you die—but you get smaller payments while you're alive

Ideally, your annuity should cover your ordinary living expenses, not you to tap your IRA for emergencies and extras. If the market plunges, you may have to postpone your Paris. But thanks to your annuity, you still be able to afford a decent Chardonnay.



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How to Avoid that Depleted Feeling

Making sure your retirement funds outlive you

BY JOHN WAGGONER

Do a quick search on the Internet, and you'll find dozens of calculators that show how much you need to save for retirement. But most of them don't tell you how much you can safely withdraw each year once you do retire so that you don't outlive your money.

In many ways, it's a knottier problem than saving for retirement. Younger savers have time to make corrections and adjust for underinvestment or disappointing returns. Those who are living off their accumulated wealth have less flexibility to make up for bad financial decision-making.

For starters, financial advisers generally recommend you don't take more than 5% of your stash the first year after you retire. You want to keep as much invested as possible. The power of compounding means your earnings in your first years of withdrawal have a far bigger impact than those in your later years.

Use that number merely as the starting point. The amount of money you withdraw annually

Schaefer's expenses have risen since her retirement

would depend not only much you've saved but also lifestyle, inflation, and of the earnings on the untouching of your money.

Consider the question much income you'll need. In the past, you have been told to aim for a retirement equal to 70% of what you earned while working. That assumption doesn't necessarily hold for more active retirees. It certainly applies to Margaret Schaefer, a retired fifth-grade teacher in Dearborn, Mich. Like many retirees, Schaefer, 64, has stepped up her spending—and that has boosted her spending.

Whether you can maintain your lifestyle depends on inflation as well as your investment earnings. To see how much havoc inflation can wreak, consider someone with a \$500,000 retirement kitty who withdraws \$25,000 a year. If inflation averages 4% a year, that \$25,000 has the buying power of \$11,050 in 20 years.

You can adjust for inflation by increasing the amount you withdraw by 4% or so each year. If you're earning healthy returns on your investments—say, 10% a year—you can do that. But you still count on having something in the bank 20 years from now. For example, a retiree with \$500,000 in a fund that earns 10% a year and withdraws 5%, or \$25,000, the first year, and increases that amount by 4% annually, will have \$1.4 million saved by year 20. But if the fund earns just 5% a year, he may have to refrain from giving himself a yearly inflation-adjusted increase so his nest egg lasts longer. Otherwise, after 20 years, he'll have only \$113,000 in his account (table).

The stock market's unpredictability makes calculations more difficult. A few years ago, it seemed reasonable to assume stocks would deliver at least a 10% annual total return. But yields were in the high single-digits, that assumption took up some of the slack. But with the U.S. Treasury bond at 5.4%, there's little room for error there, either.

If your retirement fund takes a big loss at the start of your withdrawal period, the effect is devastating and long-lasting. Let's say a \$500,000 investment portfolio suffers a 35%

**RETIREMENT
GUIDE**

**USA
TODAY**

HOW LONG YOUR SAVINGS WILL LAST

If you plan to increase your withdrawals each year to make up for inflation, you need to earn higher returns. For example, suppose you retire with \$500,000 and start with a \$25,000 withdrawal in the first year and increase your withdrawal by 4% in subsequent years. How long your money lasts will depend on your rate of return.

RATE OF RETURN	YEARS MONEY WILL HOLD
4%	19
5	22
6	24
7	28
8	35

Data: USA Today

SMART DRAWDOWNS

Our taxable funds first You'll
s on your capital gains at the
0%, or 18% for investments
e than five years.

Our IRAs or 401(k) plans next
s are taxed as ordinary in-
on withdrawal, so it's best to
w in the tax-deferred ac-
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to your Roth IRAs last Unlike
al IRAs or 401(k) plans, Roth
tax-free when you take dis-
s, provided you're at least
you've had the account at
years. Besides, your Roth
an go to your heirs tax-free.

st year of retirement and then
% for the next 29 years. If
raw 5% in the first year and
he amount by 4% annually,
balance will be zero at the
years. But if the market takes
year 5, you'll end the 30-year
h \$870,000.

's a retiree to do? Apart from
hard look at your spending,
sh reserve. Tap that first if
market slides in your early
t years. That way, you con-
investment. "That's your ul-
ety net," says Malcolm Makin,
l planner in Westerly, R.I.,
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xpenses in reserve.

strategy is to take a fixed
e of your assets each year,
n a fixed amount. That's what
ernstein, an investment ad-
oos Bay, Ore., and author of
Pillars of Investing (McGraw-
5), recommends to his clients.
approach, you'll never outlive
y. There is a drawback, how-
income can fluctuate sharply
to year, depending on the
our investments. Consider a
ho started in 1995 with
the Standard & Poor's 500-
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ear. Withdrawals would have
om \$71,000 in 1999 to \$52,000

go with occasional inflation
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annually for changes in the
price index could make you
more than you need, depleting
gs sooner. The CPI tends to
inflation by about 1% a year,
p Cooley, a business profes-
sity University in San Anto-
30 years, that adds up to real
nd that's what you need to
retirement.



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Don't Rush into Long-Term-Care Coverage

You may not need it at all, but if you do, shop around

BY CAROL MARIE CROPPER

If you work for a big corporation, you may soon get the chance to sign up for a new benefit: long-term-care insurance. About 18% of U.S. companies with 500 or more employees offer this coverage, usually at workers' expense, and more are expected to come on board. Seeing 76 million baby boomers racing toward old age, the government has provided tax incentives for both businesses and employees to buy coverage. And it's busy signing up its own workers and their relatives.

Do you need it? Financial planners usually don't recommend this coverage for those under 45, who may have more pressing financial obligations and little chance of collecting anytime soon. Even then, the premiums could be onerous for people with few assets and little income. And the well-heeled can often afford to pay for their own care. Since employers usually chip in nothing, even employees who fall in the middle—and therefore should consider coverage—might be able to find a better deal on their own.

Group plans come with major advantages, says Paula Wickland, a health-care consultant at

Towers Perrin, an employee-benefit firm. Qualifying is usually simple for employees, who may be guaranteed coverage or face only minimal health questions. (Retired employees, spouses, and any eligible relatives might have to make medical records available, sit for an interview, or fill out a more extensive questionnaire.) Since almost 20% of those who apply for long-term-care insurance are rejected, this is no small bonus. Also, many employees can save 5% to 15% with a group plan—especially if they are in poor health.

For instance, Metropolitan Life Insurance offers a plan at one company, providing \$150 a day for nursing-home or assisted-living expenses, 60% of the amount for home health care, and a lifetime maximum payout equal to five years' care, or \$273,750. It comes with a 30-day deductible—meaning you pay for the first 30 days of care—and guarantees the right to buy additional coverage later rather than providing automatic inflation increases. The policy costs \$1,750 a year for a 45-year-old employee, \$750 for a 55-year-old. A healthy, married 45-year-old would spend \$493 to buy the same coverage in an individual policy, according to Metropolitan.

Some workers, however, can do better with an individual policy, says Robert Davis, president of Long-Term Care Quote, an online shopping site and independent insurance agent. Its policies often come with discounts for being married, in excellent health, or having an association. A healthy worker in a plan might wind up subsidizing sicker coworkers. In the example above, a healthy 55-year-old would get an individual Metropolitan Life policy for \$677. It's possible to get a similar plan from Hancock for as low as \$517, after all costs, Davis says.

With a group plan, you'll be limited to the terms your employer chose. And since the contract is with your employer, if your employer might one day change the terms to allow a premium increase. An individual policy's terms can't be changed, and an insurer r

LONG-TERM CARE: GROUP VS. INDIVIDUAL

When comparing the policy your company offers with what you could buy yourself, here are some questions you should ask:

- ▶ Is it a tax-qualified policy, which allows you to collect benefits tax-free?
- ▶ Does it pay for skilled, intermediate, and custodial care? Assisted-living facilities? Home health care and/or adult day care? What about ancillary services such as cleaning?
- ▶ What is the daily benefit allowed for nursing-home care? For assisted living? Home health care?
- ▶ What is the maximum payment amount over the life of the policy?
- ▶ What sort of inflation protection is available?
- ▶ How long must you pay for care before the policy takes over?
- ▶ How does the insurer determine if you're eligible for benefits? How many hurdles are there, and who decides?
- ▶ Does the policy pay actual expenses? Customary costs? A fixed daily amount no matter what your expenses?



need for 40 years. Look for a company with top credit ratings from A.M. Best, Standard & Poor's, Moody's, and Fitch. You want a company with at least \$1 billion in assets and five years' experience in long-term care. Also, ask an independent agent or your state's insurance department how often the company has raised premiums.

Next, compare benefits with what you could get elsewhere. Make sure the policy pays for skilled, intermediate and custodial care and covers problems such as Parkinson's disease and Alzheimer's. Ask if it is portable between states. All this should be standard. You'll want to know if adult day-care and homemaker services are covered. And find out if there is a forfeiture option entitling you to some coverage if you become unable to pay the premiums before you need care.

Then, ask what is necessary to trigger benefits and who determines if you are eligible—your doctor, or one appointed by the insurer. Policies typically require proof of cognitive impairment or that you need help with a specific number of "activities of daily living," such as eating and bathing. A non-qualified policy might also list medical necessity as a trigger. See if reimbursement is for actual expenses or for the company's notion of customary cost. Indemnity policies pay a set benefit.

After all this, look at the options that can reduce price. Do you want only one year of coverage, three years, or unlimited lifetime payments? Is \$100 a day enough? How many months are you willing to pay before the policy kicks in?

If you're 65 or younger, spend for inflation protection. The best is 5% annual compounding of the benefit amount, but 5% simple growth may be enough if you're over 65. Some policies offer a guaranteed purchase option so you can add coverage later without requalifying. But such policies may stop extending this opportunity if you don't add on early.

If you go with a group plan, ask for a copy of the policy, not just the company's description. Long-term-care insurance, like fire insurance, is something you hope you'll never need. When you do, you may be living in a different state or working for a different company and may have long ago forgotten the details of your policy.

Signing up at work has a big advantage: Qualifying is usually simple. But you may be able to find a better deal on your own

petition the state insurance department to hike. by asking if you need this product. Do expect a hardy old age? Or does your family history of debilitating disease? The cost of long home care can be as high as \$126,000 a year. Such costs, those with more than \$2 million in assets should be able to pay themselves. Those with less than \$100,000 would soon exhaust their savings and qualify for Medicaid, the government's insurance for the poor. In weighing an employer policy, be sure you can take it with you if you leave the company. Then, ask if it is "tax-qualified," meaning it meets federal guidelines for long-term care and hence pays tax-free benefits and entitles you to a tax deduction for the premiums. If that, focus on the quality of the insurer. Remember, you're buying something you may not

**RETIREMENT
GUIDE**

K.O.'d by the 401(k)

Many Americans are accumulating far less than they'll need

COMMENTARY BY AARON BERNSTEIN

If you want to see the future of retirement for many Americans, talk to Thomas Zychowicz. The Milwaukee resident put in 30 years as an industrial engineer at Briggs & Stratton before he was laid off in 1998 at age 58. He had diligently socked away 6% of his pay in a 401(k) ever since B&S set up the plan in the mid-1980s. But with two teens at home and a wife who worked part-time, he couldn't afford to save more. So when his \$46,000-a-year job ended, he had just \$107,000 in his 401(k), not enough to live on for 30 more years, even with the \$1,000-a-month pension B&S owed him. He has been bouncing from job to job ever since and now earns \$7 an hour at a Kohl's department store. "My 401(k) isn't enough, so I have to keep working at least until I can start collecting Social Security," says Zychowicz.

Many other Americans may find themselves unable to retire, too. It's not just the 30%-plus decline in the stock market since 2000, although that has slashed the retirement expectations of nearly everyone. (Zychowicz's 401(k) hit \$143,000 at the peak but has since shriveled to \$91,000.) There's a more fundamental problem: The country's retirement system simply isn't working for most Americans, and the 401(k) is the prime culprit. Although many employees became infatuated with their ever-rising retirement portfolios during the 1990s stock market boom, these personal accounts have left most workers less prepared to retire than they were when companies offered old-style defined-benefit pensions.

While 401(k) advocates often deride traditional pensions as paternalistic, most companies kicked in more under that system than they do with plans that require employees to pony up at least part of the money. Only affluent em-

ployees have stepped up their own savings to compensate. Everyone else has less available for old age today than they did before 401(k)s became popular in the 1980s.

Indeed, the retirement assets of the bottom 70% of U.S. households are 13% lower now than in 1983, when the stock market was a tenth of today's levels, according to New York University economics professor Edward Wolff (chart). "I was surprised, because I thought the 401(k) revolution would have been very beneficial for the vast majority of workers," says an expert on household wealth.

The result: Many Americans will have to work longer than planned. Already, the retirement age has drifted upward after decades of decline, with a quarter of 60- to 69-year-olds working today, up from a fifth in 1991.

There are ways to improve America's retirement outlook. One would be to automatically enroll employees in 401(k) plans, since they rarely opt out once they get in the habit of saving. Congress also could increase tax breaks for defined-benefit pensions. Doing so would give companies an incentive to reinvest in the approach that worked better for most Americans. The U.S. could face an old-age crisis if nothing is done. "It's clear that Americans at the bottom lack the discretionary income to save enough for retirement," says Michael Tanner, a researcher at the conservative Cato Institute in Washington.

While many experts and political leaders have been urging Americans to save more, most no one believed that most families

RETIREMENT GUIDE

AMERICA'S TROUBLED RETIREMENT SYSTEM

It's working for the wealthiest, but not for most employees

PENSION BENEFITS HAVE FALLEN...

Average current value of defined-benefit pensions per household in 1998 dollars, by household net worth

	1983	1998
TOP 30% OF HOUSEHOLDS	\$94,000	\$76,000
BOTTOM 70% OF HOUSEHOLDS	32,000	20,000

Data: Edward N. Wolff, New York University

...401(k)s WORK BEST FOR HIGHER-PAYING

Average value of 401(k) and other defined-contribution accounts per household in 1998 dollars, by household net worth

	1983	1998
TOP 30% OF HOUSEHOLDS	\$12,000	\$12,000
BOTTOM 70% OF HOUSEHOLDS	600	600

Data: Edward N. Wolff, New York University



to more than make up the difference, everyone else is lagging. The assets the upper 30% hold in all defined-contribution plans, such as 401(k)s and individual retirement accounts, have multiplied tenfold since 1983, to an average of \$112,000. As a result, their total retirement assets—including all defined-benefit and defined-contribution wealth—have climbed by a healthy 77%, to \$188,000. However, families in the lower 70% have suffered an 11% decline. Their average old-age savings today: \$29,000.

Part of the problem is that employers have sliced the amount they kick in. On average, employers who set up 401(k)s have cut their retirement spending by 14%, according to an analysis of corporate tax filings between 1981 and 1996 by University of Notre Dame economist Teresa Ghilarducci and two colleagues. "We found 401(k)s are a cost-savings move for employers," she says.

Zychowicz diligently paid in, but he doesn't have enough to live on

As a result, workers must foot more of the bill for their own retirement. With companies covering fewer workers, and paying less for those they do cover, employers' overall spending on retirement has plunged by 22% since 1986, to an average of 83¢

an hour, according to the Labor Dept. study.

But most families in the bottom 70% don't put aside enough to make up the difference. Many don't start contributing to a 401(k) until they hit their 30s, and many also don't contribute the maximum allowed.

Worse, much of the money Americans have stuffed away doesn't represent new savings. Instead, most families have simply raided other assets to fund their 401(k)s. The net worth of the top 30%, excluding retirement savings, has climbed 15% since 1983, to an average of \$775,000, Wolff found. However, the nonretirement assets of the bottom 70% fell by about 9%, to just \$33,000. "Most families funded the switch to 401(k)s by drawing down their net worth," concludes Wolff.

It's clear that most employees need more help planning for their future. Unless they get it, many Americans may need to spend a lot more of their golden years hard at work. ■

Bernstein watches workplace trends from Washington.

Why do companies favor 401(k) plans over traditional defined-benefit schemes? Because the 401(k) system costs them far less

orse off with a 401(k) than a traditional. Instead, it has been assumed that the was with those who don't or can't set ough for retirement, mostly poor and me workers.

Wolff's analysis, the gist of which he d last spring, shows just how far be- ajority of families have fallen. The he U.S. workforce covered by a tra- pension has fallen in half since the ear- o about 20% today. Wolff calculated ent value of those pensions using the Reserve's triennial Survey of Con- finances, the definitive source of infor- n household assets. Although the data available through 1998, the results airly up-to-date picture, since the stock has sunk back to about where it was r. His conclusion: Households at all lev- lost ground. However, the pension of the bottom 70% have plunged by 0% since 1983, while those of the top e come down by only 18%. 401(k)s have allowed top-tier families

ER ASSETS DON'T CLOSE THE GAP...

ge net worth* per household in dollars, by household net worth

1983 1998

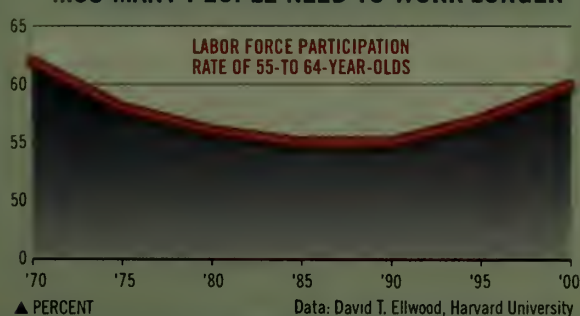
\$673,000 \$775,000

OF 36,000 33,000

as home ownership, stocks, and savings accounts, minus pension assets and all household debt

ata. Edward N. Wolff, New York University

...SO MANY PEOPLE NEED TO WORK LONGER



Cops and Teachers Are Getting Soaked



BY ROBERT BARKER

rb@businessweek.com

They're among the public servants often locked into paying high fees for inferior retirement plans

As a sheriff's deputy in the Pinellas County (Fla.) Jail, Adrian Nenu sees many tough guys. But he also has run into plenty of recalcitrant ones in the county's personnel bureaucracies. For a decade, Nenu has pushed to improve his retirement savings plan, which is full of high-cost, inappropriate investment options. He has made only modest headway. "I got the big runaround," he told me.

Yet Nenu is one of an increasingly vocal vanguard of retirement savers who keep agitating for better deals. While many corporate 401(k) plans have improved, offering more and better investment options at lower cost, so-called 457 plans for municipal workers and 403(b) plans covering teachers and employees of nonprofits remain dominated by costly variable annuities sold by insurers. These plans often cost twice as much in fees as 401(k)s (table), according to consultant Ron Bush of Brightwork Partners. With an estimated \$580 billion in such plans, an extra 1% in fees would drain \$5.8 billion each year from these employees' retirement accounts.

This remains an unhappy truth despite widespread warnings from experts against using annuities, which are already tax-deferred, within tax-deferred plans. Progress is slow. Over five years, efforts by Los Angeles school district activists have won just one small change: Paychecks now note payroll deductions as going into a 403(b) instead of a "TSA"—tax-sheltered annuity—which had implied an endorsement of annuities over cheaper mutual-fund options. The issue is surprisingly contentious. In May, a measure to create a public list of the investments available to California teachers and their fees was linked in flyers to Hitler and the Holocaust by anonymous foes. The bill's author, Assemblyman Darrell Steinberg, told me he was "offended and outraged," yet still hopes the bill will pass. Proponents complain that it since has been gutted.

Like other activists, Nenu, 37, blames ignorant local officials and an insurance industry that's intent on keeping its leading market share regardless of clients' best interests. Nenu first got annoyed back in 1992 when an insurance agent

told him and dozens of fellow deputy employee meeting that yearly fees on plan's annuities totaled just 1% of assets. Nenu learned, the fees came to 2% or

So he started campaigning. The sheriff pointed him to the county personnel department. Personnel pointed him back to the sheriff's office. Recently, I called these officials about Nenu. "He can get a little pushy," Libby, Pinellas County's personnel director said. "But other than being a son of a gun with sometimes, he knows what he's about." Yet the officials remain sadly ill-informed. Neither Libby, nor his associate overseeing the 457 plan, Sigrid Tanberg, nor the sheriff's affairs director, Bill Puller, can say what their 457 investment options cost. Tanberg told me: "We haven't been able to decipher just what the employees pay."

Nenu
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runa



PAYING UP

TYPICAL PLAN	ANNUAL COST
457 or 403(b)	2% or more of assets
401(k)	1% or less of assets

Data: Brightwork Partners

Nenu reckons investment options in his plan still average 1.8% to 2% in annual return pending on the vendor. A few—index funds—since 2000 via American International Group (AIG) VALIC—run about 1%. It offered Pinellas only after Nenu pleaded with rep, Al Sanchez Jr., who confirmed Nenu's complaint.

It need not be this way. In Florida, teachers will enroll local public employees in its 457 plan, if only their bosses ask. Federal and military personnel can save for retirement through the Thrift Savings Plan, with fees of 0.06%. Nenu thinks TSP should be extended to public employees. I think that when asking them investment choices on par with the 401(k)s is the least we can do.

RETIREMENT
GUIDE

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CKING THE BEARS



G. MARCIAL

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and RIMM
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Scoffing at the idea that the market is bottoming out is Bernie Schaeffer, editor of *Option Advisor* and head of Schaeffer's Investment Research. Nevertheless, he isn't blind to a few opportunities being created by the depressed market. He has bought shares in Ryland Group (RYL), a California builder, and in Research in Motion (RIMM), a maker of wireless handhelds with e-mail capability, such as the BlackBerry.

Both stocks are out of favor and way off their highs. But Schaeffer is impressed with their positive fundamentals and tech strength—and he likes the negative sentiment toward them.

Options traders and shorts are bearish on Ryland, with 3.8 million shares—or nearly 15% of the outstanding stock—involved in short-selling. But robust earnings growth continues, says Schaeffer, despite worries that housing has peaked. Earnings jumped 61% in the latest quarter, he notes. The stock, which rocketed from 19 on Sept. 19, 2001, to 58 on May 6, is now at 41, trading at 6.8 times analysts' consensus estimates of 2003 earnings of \$5.99 a share. Analysts figure Ryland will earn \$5.33 in 2002.

RIMM, currently 14, traded as high as 175 in 2000 during the tech craze; it now has short-interest of 13 million shares, or 15% of shares outstanding. The stock trades at just three times revenues, vs. many large-cap techs that sell at 5 to 10 times sales, notes Schaeffer. The stock rallied from 10 to 15 in early July, after RIMM reported that it beat fiscal-first-quarter estimates and that gross margins rose from 38% to 43.5%. RIMM is expected to be in the red through 2003, but Schaeffer figures it will be in the black by early 2004. "Massive short covering will initially drive up the stocks when things turn up," says Schaeffer.

A SERIOUS BID FOR MIDWAY GAMES?



Which U.S. video-game company is Japanese software giant Sega Enterprises targeting? Sega has been up-front about plans to buy video properties in the U.S. and Europe. Enter Midway Games (MWY), a designer and maker of software for video-game consoles and PCs. Midway is 29% owned by Viacom Chairman and CEO Sumner Redstone through his National Amusements. One industry exec from a rival company says Midway caught Sega's eye not only

because of its hot brands, such as *Mortal Kombat*, but also because its stock has been pummeled. Trading at 8.12 on July 1, it tumbled to 3.85 on July 3. The reason: Midway lowered its second-quarter estimates. Analysts quickly cut their 2002 and 2003 forecasts. The stock has inched up since, to 4.52, partly on rumors about Sega.

One obstacle may be Redstone, who has bought at higher prices. A fund manager who owns shares but declines to be identified says Redstone may take the company private through a leveraged buyout—unless the price is right. But whispers are that Sega, if it makes an offer, will bid below Redstone's cost of 15 a share.

A rumor at the Big Board, where Midway trades, is that Sega might offer 7 to 8 a share. After all, analysts are down on Midway because of the missed estimates. Paul Kaump of investment outfit Dougherty, who doesn't own shares, rates Midway a sell: He dislikes the lowered estimates caused by a sales drop. Midway declined comment. Sega and Redstone couldn't be reached.

SINGING MACHINE: READY TO BELT IT OUT

Fast-growing Singing Machine (SMD), big in making home sing-along karaoke machines, is staying with the beat. So why is its stock down? From 19.14 on Mar. 21, it has fallen to 10. The company was first featured in this column on Oct. 8, 2001, when the stock was at split-adjusted 4 a share. The depressed market is one big reason. Another is pressure from the shorts. Singing Machine President John Klecha, who will soon take over as CEO, says short-sellers are spreading rumors that inventories have been rising because of sluggish sales of some products.

Wrong, says Klecha: The inventory build-up is deliberate—in response to a flood of orders. Already this year, orders worth \$90 million have come in. In the current fiscal year, ending Mar. 31, 2003, Klecha expects sales to double from last year, to \$120 million. And earnings per share, he adds, should jump from last year's \$1.02 a share to \$1.60 or \$1.70.

Dan Weiskopf, managing partner at MH Capital, who owns shares, predicts that Singing Machine will exceed those estimates "quite easily." He says Singing Machine has become a sophisticated marketer, with strong links to major outlets, including Best Buy, Circuit City, and Target. He sees the stock doubling in a year, based on rapid earnings and sales growth rates.



BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:45 p.m. EST on CNNfn's *The Money Gang*.

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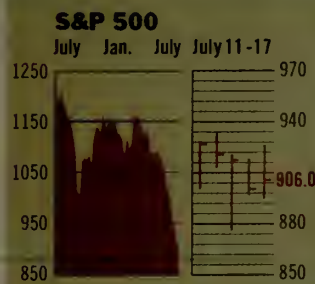
Ask your doctor if Enzyte is right for you, then visit us on the web at www.enzyte.com, or call us directly, and get started today: 1-877-4ENZYTE (1-877-436-9983).

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Stocks



COMMENTARY

Stocks fell for seven straight days before recovering on July 17. Worries over corporate misdeeds sent the Dow Jones industrial average plummeting 439 points on July 15, with the market swiftly soaring 394 points to close at 8639, down 45. The S&P 500 was at its lowest level since October, 1997. One bright spot was the Nasdaq Composite index. The dollar sagged.

Data: Bloomberg Financial Markets
Reuters

U.S. MARKETS

	July 17	Week	Year to date	Last 12 months
S&P 500	906.0	-1.6	-21.1	-25.4
Dow Jones Industrials	8542.5	-3.1	-14.8	-19.5
Nasdaq Composite	1397.3	3.8	-28.4	-32.4
S&P MidCap 400	443.6	-0.8	-12.7	-12.6
S&P SmallCap 600	203.2	-4.3	-12.5	-10.6
Wilshire 5000	8595.5	-1.4	-19.7	-23.7

SECTORS

	July 17	Week	Year to date	Last 12 months
BusinessWeek 50*	543.7	-3.1	-25.5	-34.8
BusinessWeek Info Tech 100**	295.5	2.3	-29.5	-33.0
S&P/BARRA Growth	457.0	-0.1	-23.1	-24.7
S&P/BARRA Value	446.2	-3.1	-19.2	-26.6
S&P Energy	190.0	-6.7	-10.1	-13.7
S&P Financials	305.8	-2.7	-13.9	-19.4
S&P REIT	93.7	-3.4	0.3	0.3
S&P Transportation	181.5	-4.1	-7.9	-14.7
S&P Utilities	104.3	-2.9	-28.5	-44.4
GSTI Internet	70.2	5.9	-33.1	-43.7
PSE Technology	481.6	5.1	-29.9	-29.4

*Mar. 19, 1999=1000

**Feb. 7, 2000=1000

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Wireless Services	8.5	44.3
Computer Stge. & Perphs.	4.3	26.6
Footwear	1.1	25.3
Networking Equipment	-2.4	20.0
Oil & Gas Refining	-2.6	20.0

EQUITY FUND CATEGORIES

4-week total return	%	52-week total return	%
Leaders			
Japan	0.9	Precious Metals	63.6
Diversified Pacific/Asia	-0.8	Pacific/Asia ex-Japan	13.9
Pacific/Asia ex-Japan	-0.9	Diversified Emerging Mkts.	9.6
Diversified Emerging Mkts.	-3.7	Real Estate	7.4
Laggards			
Health	-14.6	Communications	-46.3
Small-cap Growth	-14.3	Technology	-41.9
Mid-cap Growth	-14.0	Utilities	-32.0
Miscellaneous	-13.1	Health	-30.0

EQUITY FUNDS

4-week total return	%	52-week total return	%
Leaders			
ProFunds UltraBear Inv.	29.8	First Eagle SoGen Gold	101.6
Rydex Dynam. Tempest 500	29.7	Van Eck Intl. Invs. Gold A	90.4
Rydex Dynam. Venture 100	20.0	Matthews Korea	87.5
ProFunds UltraShort OTC	19.6	Rydex Dynam. Venture 100	84.5
Laggards			
Nevis	-25.2	ProFunds UltraOTC Inv.	-73.0
ProFunds UltraBull Inv.	-25.1	Black Oak Emerging Tech.	-66.3
ProFunds UltraOTC Inv.	-23.1	Van Wagoner Post Venture	-64.7
Elite New Opportunity	-22.3	Van Wagoner Technology	-62.1

Data: Standard & Poor's

GLOBAL MARKETS

	July 17	Week
S&P Euro Plus (U.S. Dollar)	942.6	-3
London (FT-SE 100)	4190.6	-5
Paris (CAC 40)	3440.9	-5
Frankfurt (DAX)	4092.8	-2
Tokyo (NIKKEI 225)	10,296.0	-4
Hong Kong (Hang Seng)	10,335.1	-4
Toronto (TSE 300)	6699.7	-3
Mexico City (IPC)	6403.3	0

FUNDAMENTALS

	July 16
S&P 500 Dividend Yield	1.76%
S&P 500 P/E Ratio (Trailing 12 mos.)	38.2
S&P 500 P/E Ratio (Next 12 mos.)*	15.7
First Call Earnings Surprise*	1.48%

*First Call Corp.

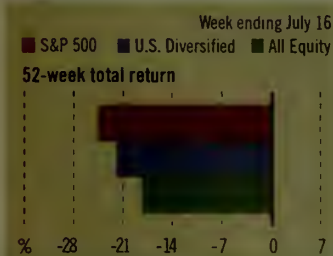
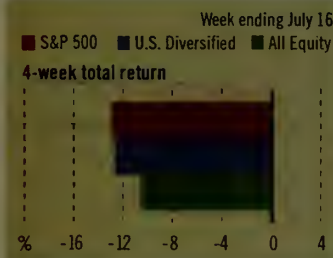
TECHNICAL INDICATORS

	July 16
S&P 500 200-day average	1096.1
Stocks above 200-day average	32.0%
Options: Put/call ratio	0.84
Insiders: Vickers NYSE Sell/buy ratio	3.61

WORST-PERFORMING GROUPS

Multi-Utilities	-32.0	Multi-Utilities
IT Consulting	-26.8	Wireless Services
Consumer Finance	-24.4	Application Services
Office Electronics	-22.9	Movies & Entertainment
Constr. & Engineering	-22.3	Telecomms.

Mutual Funds



Data: Standard & Poor's

Interest Rates

KEY RATES

	July 17	Week
MONEY MARKET FUNDS		
90-DAY TREASURY BILLS	1.44%	1
2-YEAR TREASURY NOTES	1.71	1
10-YEAR TREASURY NOTES	2.60	2
30-YEAR TREASURY BONDS	4.68	4
30-YEAR FIXED MORTGAGE†	5.45	5
	6.46	6

†BancQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENT

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 30% federal tax rate.

	10-yr. bo
GENERAL OBLIGATIONS	
TAXABLE EQUIVALENT	3.99
TAXABLE EQUIVALENT	
INSURED REVENUE BONDS	5.70
TAXABLE EQUIVALENT	4.20
TAXABLE EQUIVALENT	6.00

THE WEEK AHEAD

DURABLE GOODS ORDERS Thursday, July 25, 8:30 a.m. EDT ► New orders for durable goods during June probably grew 0.6%, after a 0.9% increase in May. That's based on the median forecast of economists surveyed by Standard & Poor's MMS, a unit of The McGraw-Hill Companies. While new orders are on the rise, factories are still experiencing a decline in the backlog of unfilled orders.

EMPLOYMENT COST INDEX Thursday, July 25, 8:30 a.m. EDT ► Compensation in the

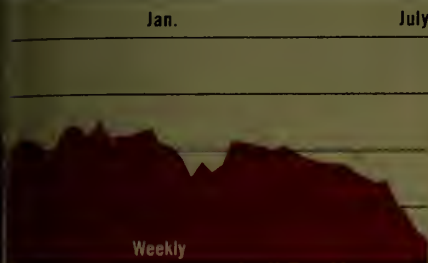
second quarter most likely increased 0.8%, after rising 0.9% over the first quarter. For the year ended in March, compensation rose by 3.9%, compared to a 4% pace a year earlier. Benefits were up by 4.9%, while wage gains increased 3.5%.

NEW RESIDENTIAL SALES Thursday, July 25, 10 a.m. EDT ► New single-family home sales in May probably retreated to an annual rate of 980,000, according to the median forecast by S&P's MMS. During

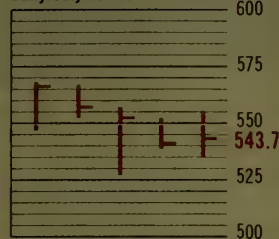
May, sales reached a record 1 million homes. The decreasing of an interest-rate hike by the Reserve in the near future is mortgage rates back down to levels of last year.

EXISTING HOME SALES Thursday, 10 a.m. EDT ► Sales of existing June are forecast to have slipped annual pace of 5.7 million. Existing-home sales edged down to million units.

BusinessWeek Fifty

THE
BUSINESSWEEK **50**

Daily: July 11 - 17



and the decline in the Dow Jones industrial average, falling 3.1%. The BW stocks were pulled down by the Financial, which plunged 40.7% on July 17 as regulators asked the company to increase its capital. Duke Energy, down 13.8% during the week, was pummeled after it admitted it conducted a safety audit. One bright spot was Forest Laboratories, up 12.9% on a positive earnings surprise.

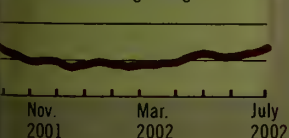
COMPANY PERFORMANCE

	% change		Rank	Company	% change	
	Week	Since 3/1/02			Week	Since 3/1/02
Johnson	1.9	-15.9	26	Tenet Healthcare	3.8	23.4
	4.1	-7.1	27	Household International	-3.9	-17.7
	-5.7	-28.6	28	WellPoint Health Networks	0.8	25.6
	-10.0	-20.0	29	Washington Mutual	-0.4	6.1
	-2.3	-16.2	30	Duke Energy	-13.8	-36.5
Kohl's	10.1	-22.9	31	Kohl's	-9.8	-6.6
	4.1	-7.2	32	Bed Bath & Beyond	-5.1	-7.2
	-11.4	-15.6	33	Cardinal Health	4.5	-16.9
	-8.3	-28.4	34	Centex	-7.2	-16.3
	2.4	-4.7	35	American Electric Power	-2.3	-21.4
Group	4.8	27.6	36	Golden West Financial	-3.0	-2.3
	-3.4	-9.1	37	Stryker	8.8	-16.8
	-7.1	-38.2	38	Harley-Davidson	-1.6	-5.5
	-10.2	-22.2	39	PepsiCo	-5.0	-16.1
	-7.1	-79.4	40	Merck	2.1	-27.4
Merck	-12.7	-0.8	41	Apache	-5.3	-2.4
	-7.3	-12.3	42	Amerada Hess	-2.6	8.4
	12.9	-6.3	43	KB Home	-7.7	5.0
	1.4	-7.5	44	First Data	9.4	-12.6
	-0.9	-27.9	45	Tyco International	-7.8	-58.8
Petroleum	-5.2	-1.5	46	International Game Technology	-2.5	-18.1
	-1.5	-17.3	47	Capital One Financial	-40.7	-38.1
	-10.7	-10.7	48	Electronic Data Systems	-0.2	-42.5
	-5.9	-12.4	49	Nabors Industries	-8.3	-9.9
	1.0	-18.4	50	Xcel Energy	7.1	-36.5

Production Index

Change from last week: 0.5%
Change from last year: -2.8%

OUTPUT July 6=163.6 1992=100
Index is a 4-week moving average



The index rose for a sixth straight week. The index is a 4-week moving average. The index rose from 164. Even after seasonal and truck assemblies rose despite the Independence Day holiday and overhauls. Steel, crude-oil refining, production posted strong gains, while traffic rose at more moderate clips. The index component to fall.

The index components is at www.businessweek.com
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CEO to-do list

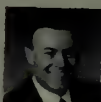
- ☐ The impossible
- ☐ The unpredictable
- ☐ The right thing
- ☐ The next thing
- ☒ Attend BusinessWeek CEO Summit

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GETTING THE MESSAGE, FINALLY

They are lining up to take the pledge. Douglas N. Daft, CEO of Coca-Cola, publicly promises to treat stock options like other forms of compensation, expensing them and taking the hit on his company's earnings. Then, Washington Post CEO Donald Graham vows to do the same. Bank One CEO James Dimon follows suit, saying expensing stock options will help "provide clarity, transparency, and accuracy to our shareholders." Growing numbers of CEOs around the country, however reluctant they may be, are responding to angry investors who no longer trust any financial numbers in the face of widespread fakery and fraud. Some, such as Michael D. Eisner at Walt Disney, are finally reforming their crony boards of directors and separating their auditors from their consultants. Pushed by the heckling from Warren E. Buffett to clean up their books, prompted by the cajoling of Goldman, Sachs CEO Henry M. Paulson Jr. to take action, the movement for corporate reform is picking up steam. But time is of the essence. Investor disillusionment is perilously high, and the bearish stock market is becoming more and more volatile (page 34).

CEOs face a gargantuan task. They have dragged their feet for months, ever since Enron imploded. Even as scandals spread to Global Crossing, Xerox, Tyco, Dynegy, ImClone Systems, and Adelphia Communications, they resisted change. It wasn't until the enormous \$3.8 billion fraud at WorldCom caused investors to back away from the market, sending it into a deep swoon, that CEOs began to wake up. Now, none other than Federal Reserve Chairman Alan Greenspan is excoriating the "infectious greed" of CEOs, saying that their behavior directly threatens an otherwise solid economic recovery.

He's right, but it doesn't get us anywhere to simply demonize CEOs, as some politicians in Congress have done in recent weeks. The goal must be to get on with reforms.

BITING THE BULLET ON REFORM

The most important of these is the tough Senate accounting-reform bill proposed by Senator Paul S. Sarbanes (D-Md.). It establishes an independent oversight board to watch accounting, forces companies to rotate the accounting partner who does audits every five years, limits conflicts of interest within the industry by restricting consulting services firms that can offer to audit clients, and mandates CEOs and CFOs of publicly traded companies to certify their financial statements. This would go a long way toward reestablishing the credibility of financial statements.

To date, President Bush has backed the much weaker House version of the bill. It's time for him to bite the bullet and put his support behind the Sarbanes bill. So should House Republicans. The markets and the nation's economy would benefit tremendously if a tough piece of accounting-reform legislation is put before the President and he signs it before Washington takes off for recess in August. Waiting for September risks further alienating investors and sending the stock market to even lower levels.

Expensing stock options is clearly the second reform that needs to be taken to restore credibility to financial statements—and CEOs. The experiment of using options to align management and shareholder interests clearly failed. It may take some time to figure out the best way to replace them. In the end, they will have to be deducted from earnings, just as all other kinds of compensation. The new standards of disclosure, transparency, and credibility overwhelmingly demands options reform, even in high-tech industries. If stock options are valuable as employee incentives, then companies must be willing to pay for them or find alternatives.

Finally, checks and balances must be restored to corporate governance. The New York Stock Exchange should follow through on its plan to require that a company's board have a majority of independent directors and that audit committees consist entirely of outside directors. The NYSE should consider requiring that the chairman be separate from the CEO. The chairman should represent shareholder interests and not commingle them with management's. And Wall Street should follow through on its early efforts to make analysts independent thinkers once again by divorcing them from investment banking. Analysts should not go on road trips to sell stock or initial public offerings to potential investors for the firm. Period.

A SLOW, EXPENSIVE PURGING

Don't expect the corporate cleansing under way now to be cheap or quick. The super-earnings of the '90s are repriced sharply downward by the markets. Standard & Poor's says that if all companies in its 500-stock index had expensed their options, earnings per share would be 24.5% lower for 2001 and 17% lower in 2002. S&P is already expensive in calculating core earnings for corporations. But the truth about earnings will be expensive.

The repricing of equity—and debt—may well take time. The market is clearly struggling with valuation. CEOs of public companies will personally sign off on financial statements to the Securities & Exchange Commission by Aug. 14. It will take months longer for others to do the same. And there is as yet no agreement on valuation when expensing them: Boeing uses one method, Coca-Cola uses another.

In the end, the cleansing of Corporate America is worth it. The economy is coming back to life, with activity rising and profits for many companies looking good. Companies seeking to keep their competitive edge at some point, have to replace their old y2k-era hardware with the best available technology. Once they believe that they can again take reasonable risks and make honest evaluations, they will return. Stocks will rise and the bear will go back into hibernation.



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INSIDE THE TELECOM GAME

How Salomon's Jack Grubman wheeled
and dealt with WorldCom, Qwest,
Global Crossing, and others

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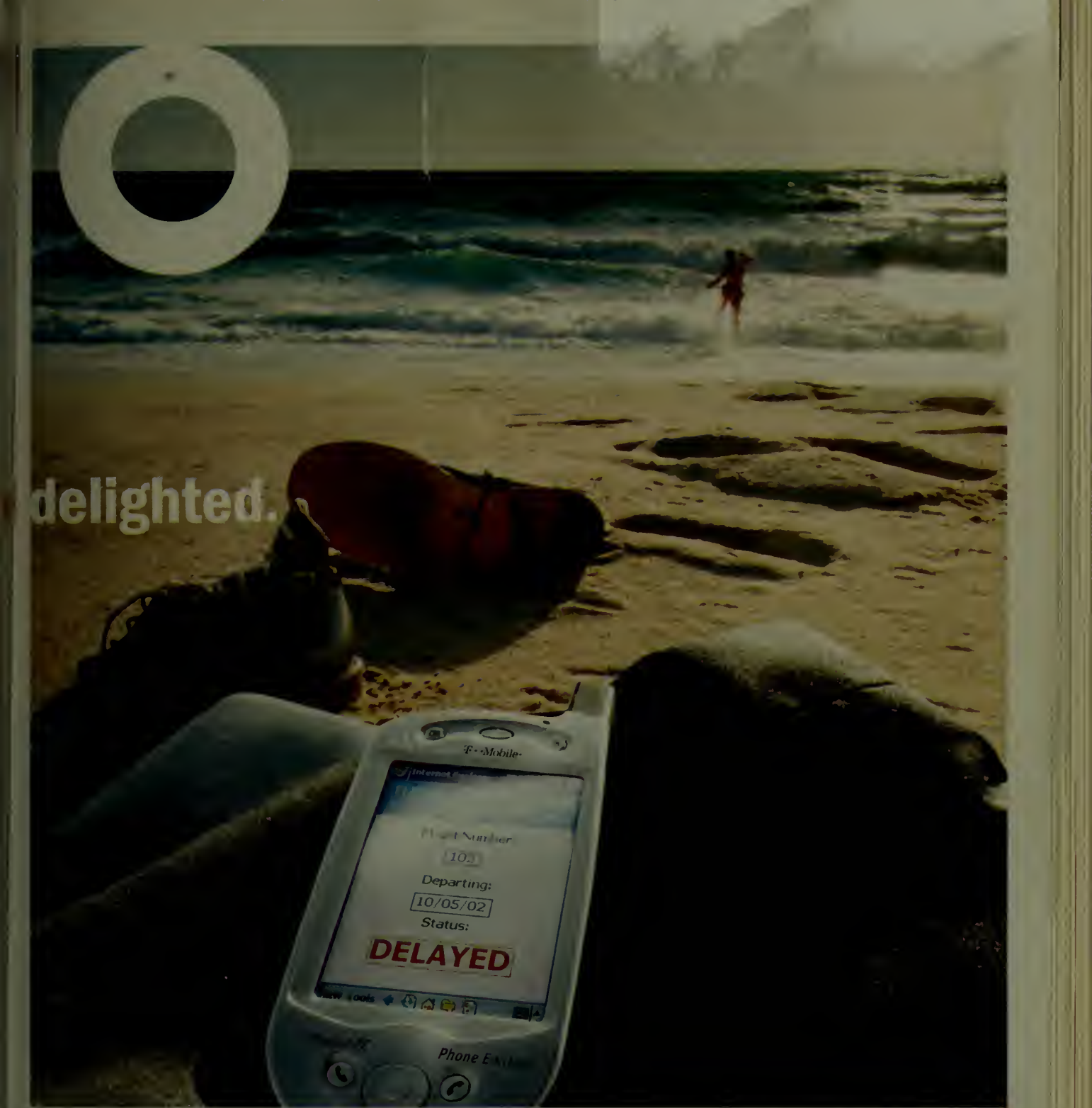
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n ice that may not be here in a hundred years

George Divoky, Ph.D., *Researcher, Institute of Arctic Biology, University of Alaska*

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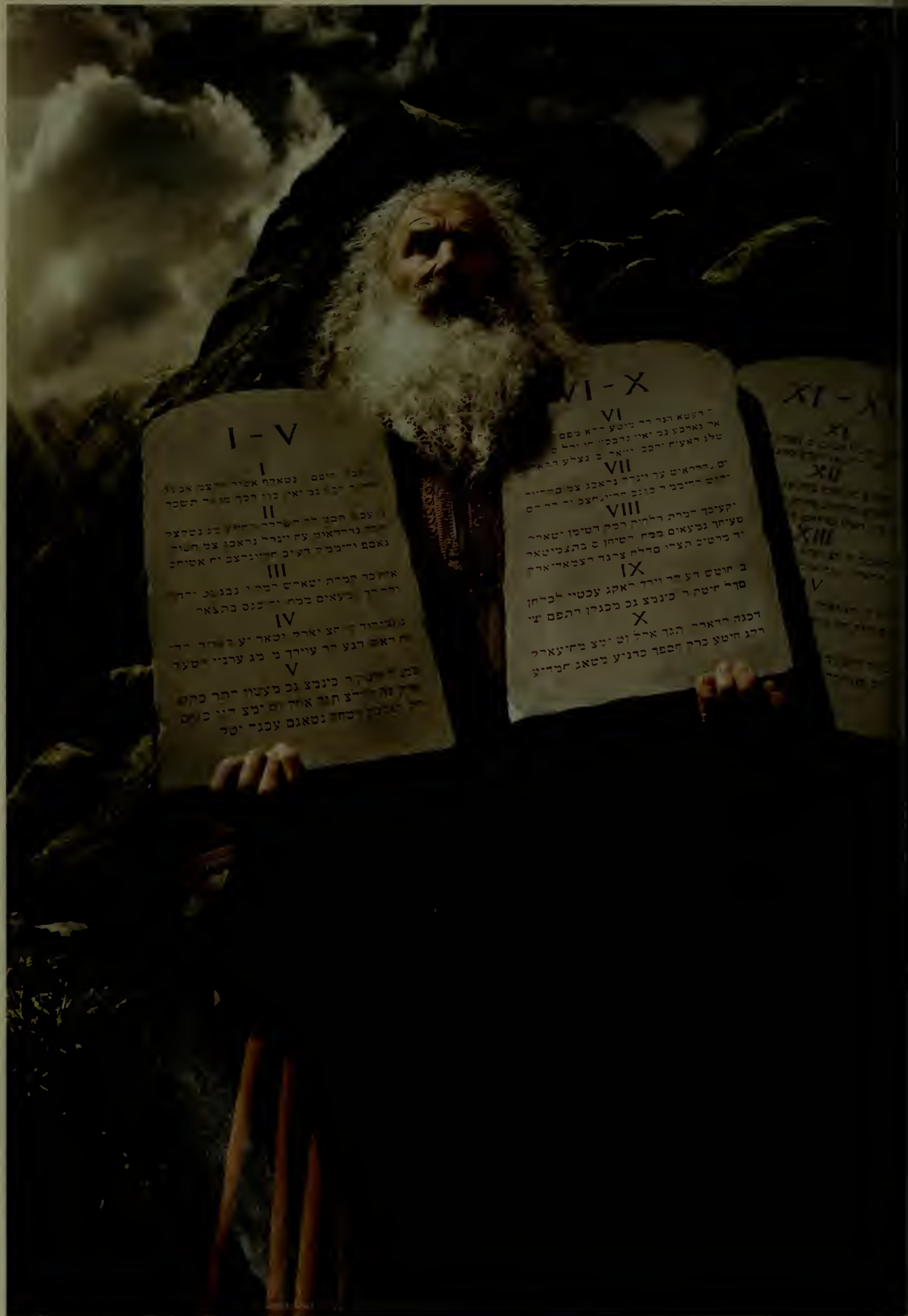
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Tools for the New Work.



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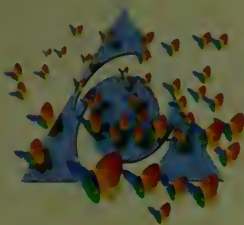


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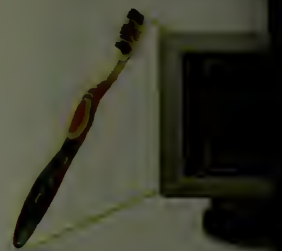
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Up Front

EDITED BY SHERIDAN PRASSO

HALL OF SHAME

AT WORLDCOM, IT'S DEJA VU ALL OVER AGAIN

SHOULD WE HAVE SEEN IT coming? A decade before WorldCom admitted to mammoth accounting fraud, it was a division of IDB Communications, a high-flying global satellite outfit that transmitted Billy Joel concerts to Russia and images of the gulf war to TVs around the world. IDB was lauded as an innovative company, and its founder, Jeffrey Sudikoff, was named Entrepreneur of the Year by Merrill Lynch in 1994.

But that was before the top execs, CEO Sudikoff and President Edward Cheramy, were indicted on charges of insider trading and securities fraud.

Here is the ugly story: The company's accountants, Deloitte & Touche, abruptly quit in 1994, citing "an inability to rely on management's representation" of its numbers—first-quarter earnings of \$8.8 million that matched analysts' forecasts.

That revelation caused the

stock to tank. And Bernie Ebbers then snapped up IDB at a discount. He merged IDB, which was based in California, with his existing telecom company and named the new



company after IDB's international division, WorldCom.

Investigations came next. The U.S. Attorney General's Office in California charged Sudikoff and Cheramy with forging documents to artifi-

TALK SHOW "I'm not a stockbroker. I'm not a stockbroker. My attitude on Wall Street is: They'll buy you or sell you depending upon if it's in their interest."

—President George W. Bush

cially inflate revenues, filing fake documents with the Securities & Exchange Commission, and selling millions worth of stock ahead of bad news. Sudikoff pleaded guilty to two counts of insider trading and one count of failing to disclose stock trades to the SEC. He was sentenced to one year in a minimally restrictive correctional facility, \$3.8 million in fines, and three years' probation. Cheramy pleaded guilty to one count of insider trading. He received three years' probation, 500 hours of community service, and \$350,000 in fines. Neither could be immediately reached for comment.

Ebbers first met Sudikoff in pre-merger talks in July, 1993—months before the accountants quit. They signed a confidentiality agreement "in anticipation of the possibility of exchanging confidential information," according to documents filed with the SEC. (Neither Ebbers nor his lawyer returned calls about events of the period.) The moral? Ebbers once benefitted from other executives' crimes. Now he could face the same music himself. *Heather Timmons*

SECOND ACTS

CAN SHE WHIP THE REST OF 'EM INTO SHAPE?

FOR SHERRON WATKINS, THE Enron whistle-blower, the collapse of her company and the soul-searching it set off may soon lead to a new career. While she still works at bankrupt Enron—making \$165,000 a year sorting out the value of Enron's assets for its creditors—she's hoping to form her own boutique consulting firm.

Watkins wants to hire high-powered retired execs and former accountants and

offer reviews of corporate-governance practices and training for directors, according to her lawyer, Philip Hilder. Such a business "would be more of a cause than a job for her," says Hilder.

Watkins fears her job prospects elsewhere could be hurt by her actions at Enron, according to Hilder, be-



WATKINS

cause potential employers might view her as a renegade. Her numerous speeches, given on her vacation time to nonprofits and universities, are mostly unpaid. And she's not counting on much of a windfall

from a book she's collaborating on, either. So, unlike the Enron bigwigs who cashed in big on stock options, look for Watkins to remain a working stiff. At least she won't be wearing stripes.

Wendy Zellner

WOW, ARE THEY THAT GOOD?

The market cap of Southwest Airlines, one of the U.S. carriers to make it after September 11, exceeds that of all other major carriers combined.

SOUTHWEST

9 - \$9.11 BILLION

8 -

7 -

6 -

5 -

4 -

3 -

2 -

1 -

0 -

▲ BILLIONS OF DOLLARS
Data by Bloomberg Finance

A man wearing a dark cap, glasses, and a blue shirt with an orange safety vest is working on a vehicle. He is looking off to the side with a focused expression. The background shows a building and some equipment.

"I figure that the oil companies
pay the motor companies not to
put out a vehicle that's cleaner,
healthier for our environment."

▲ Alfred Espinosa / Heavy Equipment Operator

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DETOURS

TOYOTA GETS THE URGE TO FLY

NOT CONTENT TO STICK TO THE road, Toyota Motor is looking to spread its wings in the growing market for small aircraft. It has been test flying a prototype for a single-engine propeller plane over the

growing leisure and puddle-jumping commercial sectors currently dominated by Cessna and New Piper Aircraft.

But it will take a few more years of testing before Toyota is ready to put it on the market. "The next step is a matter of years, not months," says Mike Michels, a spokesman for Toyota's U.S. sales unit.

This isn't Toyota's first foray into aviation. It won approval from U.S. authorities in 1996 to market a propeller-plane engine based on technology used in its Lexus LS400 sedan. That project was halted two years later after the engine was deemed too heavy and too expensive to commercialize. So there won't be a Lexus engine under the hood of Toyota's new plane. Toyota says that the engine comes from an "outside manufacturer." *Chester Dawson*



Mojave Desert since May. The fuselage is made of lightweight carbon fiber instead of the aluminum used in other small planes. That makes it more aerodynamic. Toyota plans to target the small but

MAD AVENUE

LISTEN UP, SUCKA, THE '80s ARE BACK

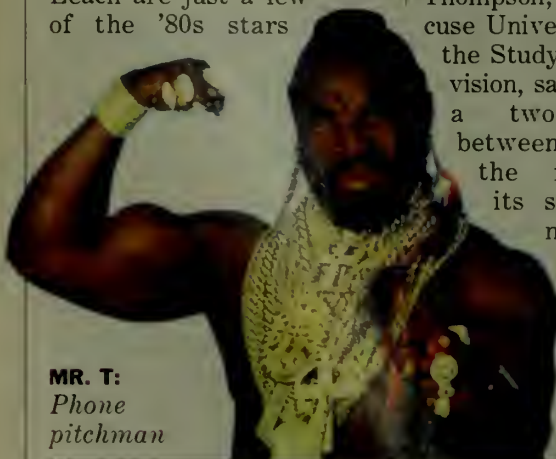
MUSIC AND FASHION FROM THE 1980s are back in vogue, so advertisers are dredging up some of the decade's iconic TV stars to pitch companies in television commercials. Alien puppet ALF, Mr. T from *The A-Team*, and *Lifestyles of the Rich and Famous* host Robin Leach are just a few of the '80s stars

making their comebacks.

ALF, whose show ran from 1986 to 1990, appears in an ad for discount phone service 10-10-220, while Mr. T endorses 1-800-COLLECT. Both are operated by Telecom USA, a subsidiary of WorldCom. Leach, who launched his celeb-watching show in 1983, is doing ads for Courtyard by Marriott hotels.

Nostalgia for the '80s comes as no surprise to pop culture experts. Robert Thompson, director of Syracuse University's Center for the Study of Popular Television, says there's usually a two-decade break between a TV show and the resurrection of its stars. "Over the next 10 years, '80s stuff will be all over the place," says Thompson. Time to break out the leg warmers?

Julia Cosgrove



MR. T:
Phone
pitchman

DRAWN & QUARTERED



BRAIN WAVES

CAN A 37¢ BRIBE GET BILLS PAID ON TIME

BILLS TEND TO SIT AROUND past their due dates. That costs telephone companies, utilities, and others millions in financing costs. So a man in Bethesda, Md., invented Urgent Reply Mail. It works like this: Along with the bill, businesses can send a special return envelope with prepaid postage, much like existing Business Reply Mail. To take advantage of it, customers must pay their bills before a cutoff date.

Bob Fredman, who patented the envelope, is trying to line up a credit-card company for a trial run. He also has been trying to sell it to the cash-strapped U.S. Postal Service. The Postal Service has been looking to prevent

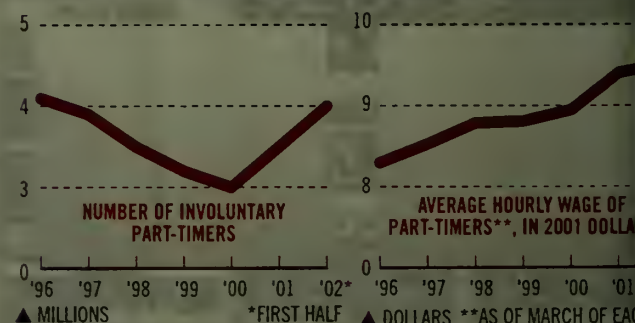
more remittance mail going electronic, but been cool to the idea though it could charge to 10¢ fee for each envelope as with Business Mail, a spokesman says question whether



really is market demand. Another snag: What envelope is sent after the cutoff date? The biller must pay the postage, says Fredman, but suspend the charge to chronic procrastinators. bump up the next bill by 37¢. *Paul Maguire*

THE BIG PICTURE

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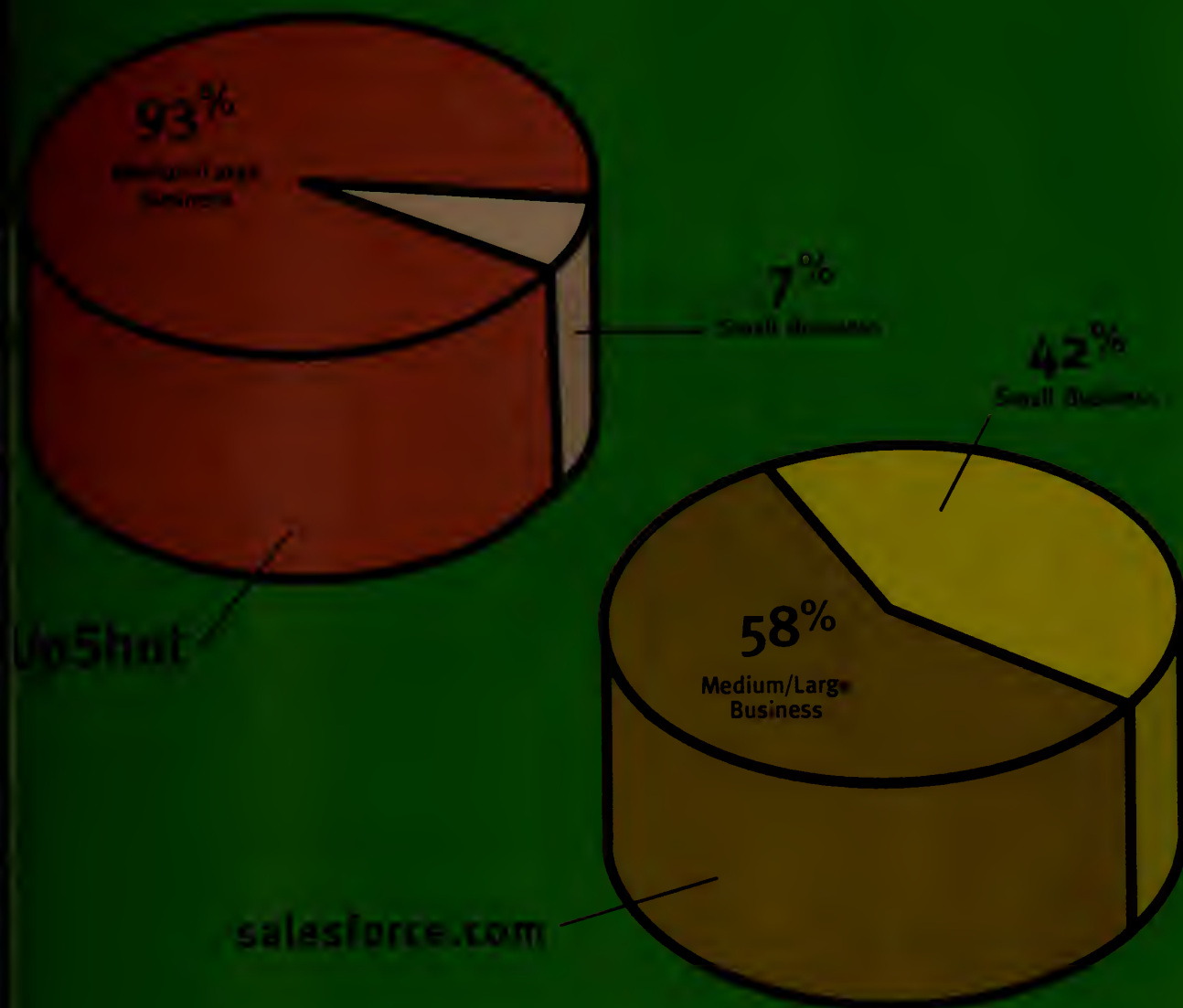
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BADLY NEEDED: AN OVERHAUL FOR DETROIT

America needs a new auto industry, where the money is put into making high-reliability cars, not ones designed so that Detroit can sell replacement vehicles ("Autos: A new industry," Cover Story, July 15). Contrast this with the legendary reliability of Japanese cars, and, potentially, Korean cars in a few years. You hit the nail on the head. Only Nissan, Toyota, and Honda are on the list for my next purchase.

Stephen Kay
Severna Park, Md.



No consumer owes loyalty to any vendor. Consumers should make companies that want their money earn it. U.S. auto makers have lost sales because of their attitude.

The next car I buy will be foreign, because I can no longer trust the quality, service, or honesty of the U.S. company I've been loyal to. I'm going to divorce them. And, watching their stock tumble recently, it looks like many other customers feel the same way.

Jim Mathis
Detroit, Tex.

Except for pickups and large SUVs, Detroit doesn't make vehicles that people want to buy. If Honda can manufacture cars with jewel-like precision across its model line, why can't Detroit do the same? When the Big Three combine the quality, engineering, and reliability of

the "overseas brands," we walk the path to their doors.

Steven
Rich

If the U.S. goes to war with a foreign nation one day, the B factories (whatever are left) will be only ones available to manufacture and armor vehicles for our men and women.

American consumers may have benefited now from the demise of domestic brands, but it will be the American domestic manufacturers that help to save America from a future

Paul
Pla

THE PEARSON STORY HAS TWO SIDES

Pearson Inc. can take criticism, ever, your story, "Can Searc Pearson out of this pickle?" (National Business, July 22), was to the point of unfairness. The quotes Sanford C. Bernstein & expecting EBITDA in 2002 to be down" on the \$945 million rep 2001. This is not a like-for-like son. In 2001, Pearson owned stake in the RTL group, which \$52 million contribution to earn stake was sold earlier this year ing EBITDA in 2002 but benefiting after interest (because pro the sale were used to pay down

The article quotes Sanford B research as saying that Pearson ing 3.3% on invested capital. point. But for fairness and balance not also report what Pearson ex have consistently said about re capital? Namely, that the process shaping Pearson—selling mature valued assets that have been ov

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Readers Report

CORRECTIONS & CLARIFICATIONS

In "Taking the downside out of investing" (*BusinessWeek Investor*, July 29), a table incorrectly stated that \$100,000 invested in a portfolio composed 80% of zero-coupon bonds and 20% of stocks would yield \$100,000 in the event of a 10% market decline. The correct value is \$118,000. The table also incorrectly stated that the same portfolio would be worth \$100,000 if the market were to remain flat. In fact, the portfolio would be worth \$120,000 under those circumstances.

Pearson for many years (and therefore carrying little goodwill) and buying faster-growth, more highly valued businesses—inevitably reduces return on capital in the short term. One of the ways to judge Pearson is not just to look at return on capital last year but how quickly it grows in the years ahead.

You say that "educational publishing, in which Scardino has invested more than \$7.2 billion, is proving far more vulnerable to the economic cycle than she reckoned." Where is the evidence? U.S. college publishing grew by 5% last year and is expected to grow by 8% plus this year. The U.S. school publishing business grew by 9% last year. At every investor presentation we've made, we have said we expect U.S. school publishing revenues to be flat this year (not because of government cutbacks but because of the way that the five-year school textbook adoption cycle works) and to increase by an average of 6% to 8% through that cycle.

You report that the education software business has disappointed but make no mention of the school testing business. This is a bigger business, and it is exceeding expectations. (It grew 15% last year and is expected to double over the next five years.) Nor do you mention that NCS—the acquisition you report many analysts consider to be a "step too far"—is set to increase its revenues by at least 15% this year.

The article reports on the scaling back of Pearson's ambitions in online education, in particular at Learning Network. Again, no complaints about that. But why no mention of the fact that Pearson also has \$1 billion of profitable revenues from education products that are delivered purely online through a seamless text/Web model?

John Fallon
President
Pearson Inc.
New York

START THOSE SMALLPOX VACCINATIONS—NOW

Citizens everywhere should mandating where elected officials s voluntary smallpox inoculation pox: Who should be immunized ence & Technology, July 15). By of 2002, the U.S. will have enou cine stockpiled to inoculate the population, yet officials dither whether they should vaccinate people beyond the frontline med emergency communities. A cont approach could lead to thousands ple being victimized by the dise fore it is contained. Assuming it fact, be contained.

While no one can credibly cla the U.S. government could have us from September 11, we all kno can save us from the scourge of pox. This time it is within their

Meg
Bedford

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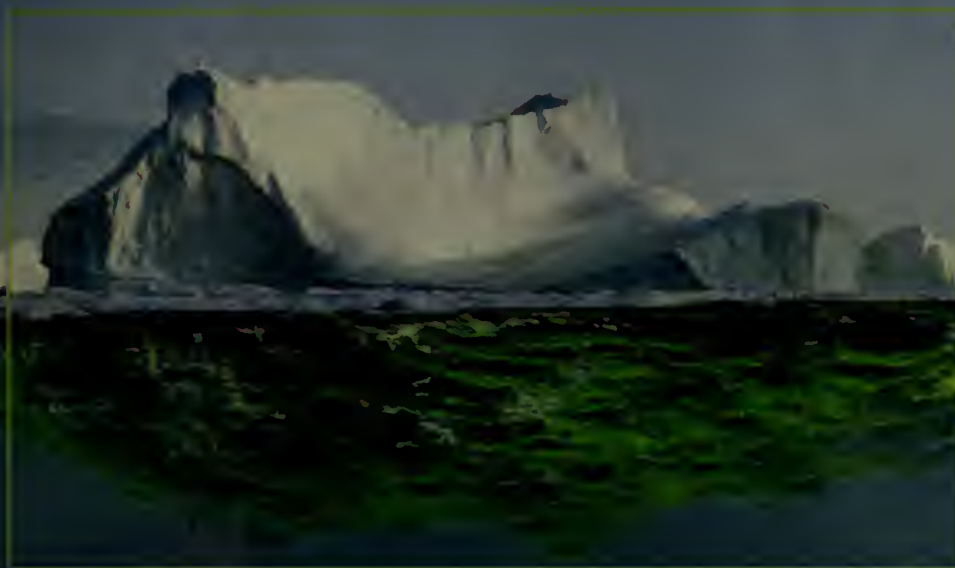
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TUXEDO PARK

A Wall Street Tycoon and the Secret Palace of Science That Changed the Course of World War II

By Jennet Conant

Simon & Schuster • 330pp • \$26

A RADAR PIONEER WHO STAYED OFF THE SCREEN

If any one technology was key to the Allied victory in World War II, it was radar. Without it, the outnumbered Royal Air Force might well have lost the Battle of Britain in 1940, German submarines could have cut supply lines across the North Atlantic, and Hitler's V-1 buzz bombs, 85% of which were shot down, could have devastated London. Many scientists helped develop radar. But one who was central to the drama has been all but forgotten: former Wall Street magnate and self-taught physicist Alfred Lee Loomis. Without his contributions, said physicist and Nobel laureate Ernest O. Lawrence, "radar development would have been retarded greatly, at an enormous cost in American lives."

Loomis' fascinating life is the subject of *Tuxedo Park: A Wall Street Tycoon and the Secret Palace of Science That Changed the Course of World War II*, by former *Newsweek* and *Vanity Fair* writer Jennet Conant. The book is a must-read for fans of World War II history, and it will captivate students of science and technology.

The author got hooked on Loomis' story because of a link to her own family's history. Her grandfather was James B. Conant, president of Harvard University from 1933 to 1953. In 1940, his brother-in-law, William T. Richards, a former chemistry professor at Princeton University, committed suicide, scandalizing the family. Adding to the family's discomfort, Richards had just written a sexy murder mystery entitled *Brain Waves & Death*, set in the sumptuous private laboratory of a supposedly fictitious dilettante scientist. To some of the East Coast's upper crust, the book was a thinly disguised account of goings-on at the place where Richards had worked after Princeton: Loomis' sprawling estate in Tuxedo Park, a snooty suburb north of New York. There, Loomis in-

stalled a state-of-the-art physics lab after cashing in his investments just prior to the 1929 stock market crash. He also built a guest house for visiting scientists and hosted such notables as Albert Einstein, Niels Bohr, and Enrico Fermi. The same house served as the rendezvous for Loomis' trysts with the young wife of his chief lab assistant. It is said that Loomis tried to suppress Richards' book, by buying every copy he could lay his hands on.

Author Conant became fascinated by Loomis and his intense penchant for privacy—which applied not only to his personal life but also to his role in many scientific advances. This secretiveness helps explain why Loomis is relatively unknown today, despite his being honored by President Harry S. Truman and King George VI.

In the 1930s, British scientists were at the cutting edge of radar technology. While crude by modern standards, their systems could spot Nazi bombers up to 150 miles from the English coast, enough of a warning for Royal Air Force fighters to intercept them. But the radar apparatus was too bulky to mount in planes, and the equipment was not sensitive enough to detect a U-boat's periscope. That changed in early 1940, when physicists at the University of Birmingham invented the magnetron. This plump copper disk was only four inches across, but its glass horns emitted short-wavelength pulses of extremely high power—just the ticket for small radars that could probe much farther and resolve details far finer than any previous system.

When Prime Minister Winston Churchill learned of the magnetron, he sensed that it marked a turning point in

the war. Given the state of British industry, though, he needed U.S. help refining the magnetron and, more importantly, producing them in volume. In August, he sent a mission to Washington where it presented a top-secret magnetron to astonished U.S. researchers.

Loomis, who had done microphysics research at Tuxedo Park and had been head of advanced radar work at the U.S. National Defense Research Committee, was in the first group to see the new magnetron. He lost no time marshaling his contacts, including Secretary Henry Stimson, a close friend. While Stimson worked to get the magnetron from Congress, physicist Loomis recruited scientists for the project.

In October, Massachusetts Institute of Technology had been picked as the site for the now-famous RadLab (Rad Laboratory). When funds ran short, Loomis would dip into his pocket to secure loans from friends. RadLab went on to design 100 different radar systems and oversee production of 1 million magnetrons that went into

equipment worth \$1.5 billion.

The war's end was bitter for Loomis. In 1945, he became a pariah by divorcing his popular but unhappy wife and, on the same day, marrying his mistress. He was 57, she was 25. Hounded out of polite society, he abandoned his Tuxedo Park lab and retreated into relative seclusion, serving on a few corporate boards and helping to form Rand Corp. He died in 1952.

Although Loomis chose to live in the shadows of great historical events, he deserves more recognition. Conant tugs this unsung hero into the sunlight so we can see his achievements. But even by the book's end, the man remains an enigma. No doubt, that's the way this champion of privacy would've wanted it.

BY OTIS

Port covers science and technology

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This month's *BusinessWeek* Best-Seller available with the August 5, 2002, issue at www.businessweek.com

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BWK&/02

BY LARRY ARMSTRONG

tech&you@businessweek.com

A KEYCHAIN NEVER FORGETS



Why tote a laptop? Pocket-size pods of memory plug into PCs anywhere

If you're like many frustrated business travelers, you've probably been trying to shed some of the paraphernalia you carry through airport security. For me, the once-indispensable piece of gear that I now routinely leave at home is my laptop computer.

Carrying a laptop has always been problematic in airports: While you're struggling with your wristwatch and cell phone or, these days, your belt and shoes, your computer is scooting down the conveyor toward parts—and people—unknown. I tried giving mine up a couple of years ago without much success. While I found I could handle most of my e-mail over a cell phone, BlackBerry pager, or wireless handheld, I never figured out how to carry all the files and data I need for day-to-day business.

Now there's a way. It's called keychain memory. A dozen or so manufacturers have come out with these pocket-size pods of flash memory, the same kind of semiconductor memory used in digital cameras and MP3 players. They snap into the USB port of any PC or Macintosh computer, where they act like just another hard drive. (They're also called flash drives.) When it's time to move on, you drag and drop your work—PowerPoint presentations, Word documents, music files, and digital movies or photos—into the portable memory, unplug it, and off you go.

It's just like the good old days when you'd slip a floppy disk in your pocket to carry your work from office to home and back. Trouble is, my laptop no longer has a floppy drive. And even if it did, many of today's data files are too big to fit on a 1.4 megabyte floppy. A couple of minutes of music? Two high-resolution photographs? Maybe.

I've been carrying a couple of these gizmos around for a month now, and I'm hooked. They're a bit on the pricey side, but the cost drops with every new entry to the market. You should be able to pick up one that can store 32 megabytes for around \$50. That's enough for several Power-

Point files, a CD's worth of MP3 tunes equivalent of a roll of high-quality film. Need more? A 128 meg model costs \$130, depending on the brand, 1 gigabyte you back a cool \$700.

Although they all work pretty much the same way, my favorite is the DiskOnKey by M-Systems, the market leader. M-Systems makes similar products for Dell, HP, Packard, IBM, and Sony. This one, which looks like a stubby highlighter pen, probably the translucent color band around its body comes with the key ring that gave the device its name as well as a clip so that you can keep it in your, um, pocket protector.

To use it, pop off the top, exposing the USB connector. Plug that into the now-ubiquitous USB port on a PC or Mac and the computer recognizes it automatically. (You'll need to

install a USB driver on Windows 98 machines.)

A tiny light on the device comes on to show that it's connected and working. When you're transferring data, the light makes, such as USB, the device

from JMtek and the Drive from Tre International, similarly.

I've also been playing with the one on the market Disk's Cruiser. Here's the twist: You can use it. The housing, the size and shape of a Zippo lighter, is a conventional pocket-size SD card, so you can up in capacity. The price of flash memory comes down, but the problem is the slightly bigger than the others, a squarish shape that gets in the way

INSTANT RECALL

Find a USB port, connect DiskOnKey, and play tunes or look at snapshots

try to connect it to a crowded USB hub. It's with a short cable to solve that problem.

If you're a real memory hog, you can use Toshiba's 5 gigabyte hard drive for about \$100. The credit-card-size drive is designed to slot into a PC Card slot. While those are common on portable computers, you'll need a PC Card reader should you want to swap material with a desktop computer. However, just like the other devices, Toshiba's PC Card drive is self-insulating so that you can use it on anyone's machine.

There are cheaper ways to keep your work handy without lugging a laptop. You can write it on a Zip disk and hope to find a matching drive at the other end of your journey. You can burn it on a CD, but try fitting that in your pocket. For my money, I'm sold on keychain gadgets. If only they were a little smaller so they wouldn't get lost in my bag.

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BY GARY S. BECKER

OPTIONS ARE USEFUL— BUT ONLY IF THEY'RE USED RIGHT



REFORM:
Changing
the way
options are
doled out
would boost
transparency
while still
pushing
execs to
strive for
excellence

Gary S. Becker, the 1992 Nobel laureate, teaches at the University of Chicago and is a Fellow of the Hoover Institution.

The growing use of stock options in the 1990s has been partly blamed for the bubble in tech stocks during that decade and for some of the misleading accounting practices of Enron Corp. and other companies. But politicians and others have excessively criticized options, which are a valuable tool that can encourage management to work effectively for their companies.

Options only add to management compensation if a company's stock rises above the exercise price. This gives managers incentives to work hard to increase profits and raise share prices enough to make their options more valuable. Greater profitability usually also benefits employees, stockholders, and others with close ties to the company. Options also penalize managers when companies do not do well; their options then become of little value and are unlikely ever to be exercised.

To be sure, some boards of directors deserve severe criticism because they have given management too many shares that are too easily "in the money." But the misuse of options by some companies is not a sufficient reason to ban them, as several prominent money managers have recommended. Instead, a few reforms would allow stockholders and others to monitor a company's options commitment, and yet at the same time do an even better job of rewarding managers for superior performance.

Options are both compensation for executives and also potential costs to stockholders, since their exercise dilutes stockholder ownership rights. For this reason, and to provide clear information on the generosity of outstanding options, the value of the options given in any year should be deducted from revenue in that year. One way to estimate value is to use the Black-Scholes formula, which links the value of an option to such variables as the current share price, the exercise price, expected volatility in share prices, and expected dividends.

Business leaders have generally opposed efforts to require them to add the value of newly issued options to costs. That's true even though they might be able to reduce their tax liabilities by lowering reported profits when options are issued, rather than later when they are exercised. It is disturbing that most companies seem to prefer raising reported profits over cutting their taxes.

Still, I do not believe Congress should make it mandatory to account for options in this way. Coca-Cola Co., Boeing Co., and a few other leading companies recently made the right decision to

include estimated values of new options of costs, and market forces will pressure to follow their lead.

Many companies have been severely criticized because they often reprice options when share prices dip so low in value that the options are "out of the money." These critics oppose repricing because they believe it eliminates financial discipline for executives whose mismanagement caused a company's stock to fall. However, repricing is warranted when declines in stock prices are not the fault of management.

Salaries and "normal" bonuses should compensate management for average performance compared with competitors. Options, on the other hand, should only reward business leaders who help their companies do unusually well. They should not be paid simply for success in a booming industry. Moreover, executives should not be punished for declines in share prices that are due to hard times for the whole industry.

A simple way to reward management for top performance is to make options dependent on the performance of a company's share price relative to that of average shares in that industry. For example, instead of an exercise price equal to a company's share price on the issue date, options could be "at the money" when the ratio of its share price to the industry's average share price is equal to what that ratio was on the issue date.

With such a measure of relative performance, options on shares whose price has risen below the average for their industry would be "out of the money." Yet, by the same token, options might be valuable if the company's share price had fallen by much less than those of competitors.

Such a system would punish management when a company's shares fall a lot relative to competitors', but that may not be enough discipline for substandard management that produces dismal results. I have long believed that boards are too lenient with badly performing CEOs. Just as coaches are often fired when their teams do poorly compared to competitors, many CEOs who greatly underperform competitors should be let go.

Options are a valuable business instrument when they only reward unusually good management and punish bad management. And option values should be added to accounting costs when they are granted instead of when they are exercised, so that stockholders could see immediately if management is being excessively compensated relative to their performance.



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EDITED BY MICHAEL J. MANDEL

ABOUT THAT RAISE YOU DIDN'T GET...

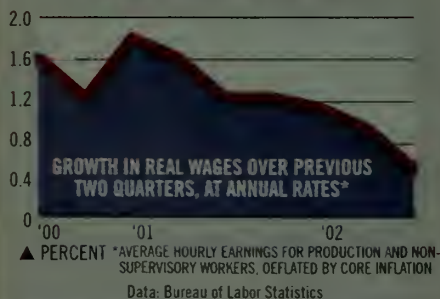
A loose job market flattens wages

The last couple of weeks have brought more news of job cutbacks at companies such as Lucent, SBC Communications, Intel, and Siebel Systems. Such layoffs, if they continue, make it unlikely that the unemployment rate, now at 5.9%, is going to drop soon.

That's bad news for workers who were hoping for pay hikes to make up for their shrinking stock portfolios. With unemployment high, real wage growth has slowed sharply. In the second half of 2000, average hourly earnings for production and nonsupervisory workers rose by 1.8%, after adjusting for inflation. That fell to 1.1% in the second half of 2001, then to a paltry 0.5% in the first two quarters of 2002.

Real wage growth may even go neg-

HOW LOW WILL WAGE GROWTH GO?



ative sometime soon. An unemployment rate of 6% is likely high enough to exert downward pressure on wage growth. Certainly it was true during the early 1990s that real wages kept falling until unemployment was well below 6% on a sustained basis in 1995.

Some hard-hit industries are already seeing wages falling even without adjusting for inflation. The latest numbers show wage declines over the past year at telephone-equipment makers, electronics stores, advertising and public-relations firms, book publishers, and companies doing integrated systems design. Other industries with wage hikes below the rate of inflation include magazine publishers, commercial printers, and temporary help agencies.

Some industries have resisted the downward trend. Pay at hospitals rose 6% over the past year, while wage

growth has stayed strong in computer maintenance and repair as companies fixed their current gear rather than buy the latest technology. And wages rose 5.9% in the accounting industry over the past year.

But high unemployment will eventually curb wage growth even in these industries. After the 1990-91 recession, it took four years for real wages to start climbing back. The same thing could happen again.

JAPANESE-STYLE WOES IN GERMANY

Without reform, big problems loom

Chronically weak growth, minimal inflation, mediocre productivity, and a plunging stock market: Today's Germany looks much the way Japan did in the early 1990s. If Berlin doesn't take urgent action to deregulate sclerotic markets and give the economy a boost, economists warn, the nation could get sucked into a vicious Japan-style circle of near-zero growth, declining competitiveness, and falling prices.

"Gone are the days when Germany was a locomotive for the rest of Western Europe," says Jörn Quitzau, an economist at Deutsche Bank in Frankfurt. "The fear now is that it could become a second economic trouble spot [like Japan], with little momentum and reliant on other countries for most of its growth."

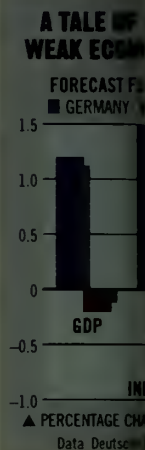
The situation isn't as bad as it is in Japan. Unlike Japan, Germany is expected to show positive growth in 2002, and the country has still not sunk into deflation (chart). Moreover, because Germans are covered by generous social security schemes, they don't need to build up huge precautionary savings accounts, as the Japanese have done. As a result, domestic demand has held up better in Germany. And while problem loans are mounting, German banks are far stronger than their debt-laden Japanese counterparts.

But Germany's prospects are deteriorating by the day, and policymakers are unwilling or unable to take action. The Bundesbank can't cut interest rates to kick-start growth—it lost the freedom to do that when the euro was launched in January, 1999. And it's difficult for the government to oil the wheels with extra public spending or tax cuts since its budget gap is very near 3% of gross domestic product, the ceiling imposed by the European

Union's Stability & Growth Pact. A general election in September, whether the government nor the opposition is willing to champion much-needed but unpopular reforms, such as market liberalization.

Many economists predict that whoever wins the election will come under intense pressure from business, the financial markets, and Germany's European Union partners to force through major changes, especially painful restructurings. But, like Japan, Germany is governed by consensus, which makes it difficult to implement controversial reforms. "The conservative society is unlikely to provide the flexibility needed in today's rapidly changing business world," says Quitzau. Germany and its trading partners could be forced to find that out the hard way.

By David F.



THE PAYOFF FROM DRUG REHAB

It's cheaper than jailing criminals

It has long been common wisdom that drug addiction is linked to criminality. During the 1990s, however, policy focused more on putting criminals behind bars and less on treatment.

But a study suggests that spending more money on treating drug addicts would pay off as well. Mireia Jofre-Bonet and Jody L. Sindelar, faculty at the Yale School of Public Health, examined data on 3,500 inner-city users entering treatment in the Philadelphia area between April and May, 1998. The data recorded criminal behavior as well as the change in the use of different drugs, such as heroin, during treatment.

The authors found that treating drug abusers reduced the crime they committed by 51%. Jofre-Bonet and Sindelar also note the cost advantages of treatment over prison. A year in jail costs \$23,000 per inmate, compared with a \$3,000 annual tab for methadone treatment of heroin addiction.

By Margaret P.

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BY JAMES C. COOPER & KATHLEEN MADIGAN

THE ECONOMY LOOKS SOLID, BUT INVESTORS DON'T REALLY CARE

Their distrust is sinking stocks, which may take a toll on growth

U.S. ECONOMY

A month ago, when the Dow Jones industrial average was beginning to fall through 9,000, investor nervousness was palpable but divorced from the improving economic outlook. After the Dow slipped below 7,800 on July 22, a new worry has emerged: At what point does the stock market's plunge fall back on the economy?

Don't look for an exact number. No economist could make such a prediction. But a continued market decline will eventually destroy enough wealth and constrict overall financial conditions so much that households will freeze up and businesses cannot finance their operations. The result would be reduced spending and reduced saving by consumers, and a new round of cutting and layoffs by businesses. In other words, the result would be a recession.

Are we there yet? Probably not, especially given the Dow's 489-point surge on July 24. But while there are still reasons for optimism, the sharp turn in investor psychology raises the risk of a new round of economic weakness. Consumers and businesses are losing confidence in the future. Bondholders see corporations as somewhat riskier borrowers

PREMIUMS ARE UP, BUT NOT BY MUCH



JULY 17, '02

Source: Moody's, DRI-WEFA, BusinessWeek

they did just last February (chart). Investor misperception continues to generate uncertainty, the bane of efficiently functioning markets. And now, bourses abroad are falling as accounting questions go global.

Why is the stock market running counter to recent data of improvement in the economy? By design, the economic data reflect only the benefits coming from sharp cyclical adjustments of the past year and a half. But this time, the adjustments in the stock market are not economic. They are psychological. The economic numbers do not address the damage that has been done to the psyches of investors and corporate executives. Rising orders and slowing inflation can't repair the mistrust among investors. And therein lies the biggest risk to the outlook.

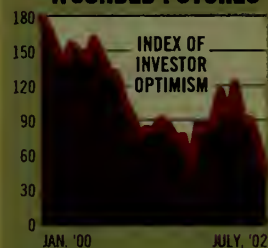
OVERALL ADJUSTMENT

in Wall Street's mind-set actually began two years ago, after the late-1990s tech and dot-com booms went bust. Investors, businesses, and consumers had to face a new reality of diminished

expectations and increased risk. Now, trust is the overriding concern among investors. And the issue is not faith in the economy—it is a lack of faith in corporate honesty and government leadership. Investor optimism is below its post-September 11 level (chart).

As a result, investors are placing a high priority on government actions to underpin the market. According to a recent survey of 1,000 investors by UBS Warburg and Gallup Poll, 64% believe that new Securities & Exchange Commission regulations addressing accounting issues would have an "extremely large or fairly large" impact on the financial

INVESTORS' WOUNDED PSYCHES



INDEX: 1996=124

Data: UBS Warburg, The Gallup Organization

markets. Federal guidelines on ethical standards for corporate management and strict prison sentences for corporate managers convicted of fraud also scored high on potential market impact. The results suggest that quick action could buoy the market, turn around shareholder sentiment, and lessen the risks to the economy.

The risk to the expansion is if investor attitudes do not change fast enough. Consumers could start to save more of their income in an effort to make up for stock losses, causing a cutback in spending. Weaker demand, coupled with a further rise in risk premiums, would hit the still-shaky corporate sector. Keep in mind that by this past spring, businesses were beginning to open up their capital budgets. But new uncertainty and financing worries might arrest the nascent capital-spending recovery. Instead, business could feel the need to cut costs further by laying off more people. That could cut into consumer spending.

DESPITE ALL THESE DANGERS,

however, the stock market probably has not fallen enough to cause a new recession. One reason for optimism is that the economy made huge cyclical adjustments during the 2001 recession. Businesses have already slashed inventories and costs. They continue to post stellar productivity gains, and they have largely eliminated excess production capacity. While investors obsess over the scandal *du jour*, what has gone unnoticed is that profits are now rising at a great many companies (page 50).

Meanwhile, consumer fundamentals remain stable even with the free-falling Dow. The three-month decline

Business Outlook

in jobless claims indicates the labor markets are stabilizing, and household incomes are growing comfortably faster than inflation. Jobs and incomes are always more important indicators of future consumer spending than trends in the stock market.

Obviously, punier stock portfolios are making consumers think twice about the future. However, because of falling mortgage rates—now down 75 basis points since March—and supportive demographics, strong housing demand is buoying home values, which has offset some of the loss of stock wealth.

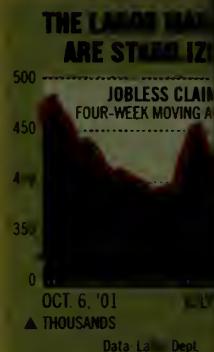
Since the stock market peaked in March, 2000, households have lost more than \$6 trillion in directly-owned equities and mutual funds, according to Fed data. During the same period, the values of all homes, less outstanding mortgages, rose by \$1.2 trillion. To be sure, a 24% offset may not seem like much, but since there are more homeowners than shareholders, increasing home values benefit a larger segment of the spending public.

EQUALLY IMPORTANT, financial conditions have not deteriorated as much as the stock market drop would suggest. The Federal Reserve has indicated that it will keep monetary policy highly accommodative. And the weakness in commercial and industrial loans at banks reflects soft loan demand because of reduced inventory levels, not an unwillingness of banks to lend. C&I lending is closely correlated with inventory trends.

Further out on the yield curve, the bond remains responsive to corporate credit needs. In March, borrowing rates are down 45 basis points to 6.11%, for AAA-rated companies; and 50 basis points to 7.35%, for BBB-rated borrowers. Risk premium for corporations must pay over and above the yield on the riskless Treasury bond have indeed risen, but it is still below the level seen right after September 11.

In addition, the 9% depreciation in the trade-weighted dollar since February is tantamount to an easing in monetary policy. It is helping manufacturers to boost exports and compete against imports, and it will lift profits from multinational operations.

The problem is that economic models simply aren't programmed to take account of mood swings such as those that have dominated Wall Street for the past few weeks. Nonetheless, moods are crucial to how people behave, even faced with increasingly good news on jobs, production, inflation, and interest rates. And it's this disconnect between mistrust of the stock market and actual economic performance that makes the recovery so vulnerable right now.



CANADA

PRICE WORRIES PROMPT A HIKE

Faced with rising inflation worries, Canada's monetary policymakers decided to take a tighter stance than that of their major trading partner, the U.S.

On July 16, the Bank of Canada hiked its overnight bank rate by a quarter point, to 2.75%. It was the third hike since April, even as the Federal Reserve is holding its target rate steady.

While the BOC does not always move in lockstep with the Fed, this is the first time since 1998 that the Canadian rate is a full percentage point higher than the U.S. federal funds rate. Back then, a jump in unit labor costs raised Canadian inflation worries.

Now, the fear is that the economy is growing so fast it will be at full capacity by early 2003 and thus vulnerable to rising price pressures. That was the explanation in the July 24 update of the BOC's *Monetary Policy Report*. In June, the yearly core inflation rate was 2.1%, right in the middle of the BOC's target range of 1% to 3%.

The Canadian economy is already showing signs of slowing, after a 6% annual rate surge in the first quarter. In May, both retail sales and wholesale shipments fell. And the trade surplus narrowed because of a drop in May exports. Nonetheless, real gross domestic product probably grew at an an-

nual rate in excess of 4% in the second quarter, at least twice expected U.S. advance.

Real GDP is projected to grow 3% to 3.5% in the second half. That pace is strong enough to reduce the unemployment rate from 7.5% in June and to keep industrial production growing. However, expectations for a slower economy clobbered the Canadian dollar on July 22 and 23. It suffered its worst two-day loss ever. A weaker currency will keep an upward pressure on prices in the months ahead, even as growth eases.

So while the BOC's latest report suggests the bank prefers to sit on the sidelines for a while, the expected tightening in the labor markets and industrial capacity means policymakers won't be able to delay another rate hike for very long.





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How a small group of insiders made billions as the industry collapsed

Telecom has been a disaster for just about everyone. Investors have lost some \$2 trillion as stock prices have tumbled 95% or more from their highs. Half a million workers have lost their jobs during the past two years. Dozens of debt-laden companies, from Winstar Communications to Global Crossing, have collapsed into bankruptcy. And on July 21, the sector sank to a once-unimaginable low when WorldCom Inc., the company that embodied the industry's power and promise, filed the largest bankruptcy claim in U.S. history.

Yet a small group of CEOs and financiers managed to save the family silver before the house burned to the ground. Philip F. Anschutz, founder of ailing local and long-distance upstart Qwest Communications International Inc., reaped \$1.9 billion from company stock sales since 1998. Former Qwest CEO Joseph P. Nacchio sold \$248 million worth of stock before he was pushed out of the scandal-plagued company in June. Global Cross-

ties among them are little understood even today. The group was linked through Salomon Smith Barney's telecom analyst Jack B. Grubman, the son of a Philadelphia municipal worker who rose from his blue-collar roots to become one of the most powerful players on Wall Street. He helped raise money for Qwest, Global Crossing, and WorldCom, recommended their stocks to investors, attended board meetings, and was elbows-deep in working with them to plot strategy.

Grubman's influence stretched far beyond the three companies that have collapsed in scandal in recent months. According to Thomson Financial Securities Data, Salomon helped 81 telecom companies raise \$190 billion in debt and equity since 1996, the year the Telecommunications Act was passed to deregulate the telephone industry. In return, Salomon, part of Citigroup, received hundreds of millions in underwriting fees and tens of millions more for advising its stable of telecom players on mergers and acquisitions. Grubman himself was paid about \$20 million a year.

So powerful was Grubman in his heyday that he could direct development of the telecom industry. Like junk-bond king Michael Milken at the height of his power in the 1980s, Grubman's word was good as gold. He could raise millions for startup players, win investor support for a proposed acquisition, or boost a company's stock price. On Mar. 14, 2000, for example, he raised his price target for Metromedia Fiber Network, which Salomon had taken public, and its shares surged 16%, to about \$46. MFN filed for bankruptcy in May. "Jack orchestrated

with the companies he covered critics felt that made it impossible for him to be objective about those companies' prospects. For example, he recruited Nacchio as Qwest executive in 1997, and he aided Crossing's Winnick in his \$11 billion acquisition of Frontier Communications in 1999. Could Grubman then step back to make critical assessments about Qwest and Global Crossing for investors?

In the wake of the telecom meltdown, Grubman is facing more intense scrutiny than ever before. As the telecom industry began deflating in 2000 and 2001, other analysts began to warn that the industry was straining under the weight of excess capacity and enormous debt. They continued urging investors to load up on shares of Qwest, Global Crossing, WorldCom, and others. In March, 2001, Grubman issued a "State of the Union" report in which he wrote: "We believe the underlying demand for network services remains strong.... In fact, we believe that telecom services, as a percentage of [gross domestic product], will double within the next seven or eight years." Now, investors are questioning whether Grubman was motivated by true opinions—or by the millions of dollars he received from supporting his own clique.

Grubman, 48, knew he was on a line few analysts dared traverse. He forcefully defended his dual role in a 2000 profile in *BusinessWeek*, where he was the model of the modern Wall Street analyst. "What used to be a conflict is now a synergy," he said at the time. "Someone like me, who is banking on the industry, would have been looked at

INSIDE THE TELECOM

ing founder Gary Winnick sold \$734 million of his shares before his company filed for bankruptcy in January. And former WorldCom CEO Bernard J. Ebbers borrowed some \$400 million from his company before he was ousted in April—and that loan remains to be repaid.

What do these execs have in common? They were all central players in a tight-knit telecom clique that dominated the communications industry in the second half of the last decade. Individually, some of these men were well known, but the

the industry," says analyst Susan Kalla of investment company Friedman, Billings, Ramsey Group Inc.

Individual investors may have jumped at Grubman's picks because they thought he was doling out impartial advice on his favorite stocks—the traditional job of Wall Street analysts. But Grubman's interests were deeply conflicted, and he came to personify the blurred lines between research and investment banking in the boom. More than any other telecom analyst, he was actively involved

fully by the buy side 15 years ago. "they know that I'm in the flow of what's going on." At the time, Sanford C. Bernstein's chairman, voiced support for Grubman's activities, though he said analysts have to maintain their objectivity as stockpickers or "they will lose credibility." Both men declined to comment for this story.

Grubman's credibility was shaken even at the time. In the 2000 *BusinessWeek* report for the first time, it was noted that Grubman had lied on his official



GAME

lomon biography for years—claiming he had graduated from the prestigious Massachusetts Institute of Technology when his alma mater was really Boston University. He admitted the discrepancy at the time. “At some point, I probably felt insecure, and it perpetuated itself,” he said. He also claimed to have grown up in South Philadelphia when he really was from Oxford Circle in the northeast part of Philadelphia. Both are blue-collar neighborhoods. But South Philly is a more historic neighborhood, the stomping grounds of singer Frankie Avalon and movie boxer Rocky Balboa, and would hold more appeal for a one-time amateur boxer like Grubman.

Despite such issues, Grubman was able to wield his influence in the telecom industry, which benefited his inner circle. When analyst Vik Grover of Kaufman Bros. LP questioned Winstar’s prospects in January, 2001, Grubman blasted him in a research note issued later that day. “We believe this is highly irresponsible of the analyst since they do not have coverage of [Winstar], nor did they speak with senior management,” he wrote. He also chastised Grover during Winstar’s quarterly conference call on Feb. 1. That helped buoy Winstar’s stock—but only for several weeks. Short of cash, the company, under CEO William Rouhana, filed for bankruptcy two months later, in April. The National Association of Securities Dealers is investigating whether Grubman’s recommendations on the stock violated its standards for stock analysts.

Nowhere was Grubman’s loyalty more evident than with WorldCom. Other Wall Street analysts, including Daniel P. Reingold of CS First Boston, stopped recommending the stock last year because of its deteriorating long-distance business and slowing growth rate. Yet Grubman reiterated his “strong buy” regularly in 2001 because, he said, it had the “best assets in the telecom industry.” Grubman didn’t downgrade WorldCom to a “neutral” until Apr. 22, when the company slashed its revenue targets for 2002. By that time, WorldCom’s shares had dropped about 90% from their peak, to \$4.

Grubman’s allies may have benefited from his actions in other ways. According to a lawsuit filed by David Chacon, a Salomon broker who was fired in 2000, Grubman doled out shares in hot initial public offerings to Ebbers, Nacchio, and several other telecom executives to win investment banking business. Ebbers allegedly received stock in broadband provider Rhythms NetConnections Inc. at the time of its initial public offering in 1999. When the upstart’s stock soared

229% in the first day of trading, Ebbers cashed out for a \$16 million profit, according to the suit. If Chacon’s allegations are true, Salomon may have violated securities regulations that bar investment banks from paying individuals for banking business. Salomon denies the assertion.

Now, Grubman’s entire network is unraveling. The Securities & Exchange

Commission is investigating WorldCom’s alleged accounting improprieties, which has become a criminal probe. Crossing is under investigation by the Securities & Exchange Commission, FBI, and two congressional committees. WorldCom faces scrutiny from the Justice Dept., and the House & Commerce Committee. WorldCom admitted to a \$3.8 billion accounting

Jack’s Inner Circle

In the second half of the 1990s, Citigroup’s Salomon Smith Barney and its star analyst, Jack Grubman, sold investors on a dazzling vision of a dynamic telecom industry. The firm helped raise \$190 billion in debt and equity for 81 telecom players since 1996 and in many cases provided additional investment banking advice. All told, it received \$1.2 billion in fees for its work. Grubman typically recommended the stocks of those companies to investors. Although he was paid about \$20 million a year, Grubman’s picks have been disastrous: Many of those companies have filed for bankruptcy, including WorldCom, Global Crossing, and Winstar. Here’s a look at how Salomon, Grubman, and the inner circle of telecom executives made off with billions while investors got burned.

Data: Thomson Financial Securities Data

WORLDCom

Salomon Smith Barney and Grubman helped former CEO Bernard Ebbers orchestrate the \$43 billion acquisition of WorldCom in 1998. Ebbers borrowed \$4 billion from WorldCom—which he still owes—before he was ousted in April. The company admitted to nearly \$4 billion in accounting irregularities and has filed for bankruptcy.

Capital raised by Salomon

\$24.7 BILLION

Salomon’s fees:

\$140.7 MILLION

WINSTAR

The National Association of Securities Dealers is investigating Grubman for allegedly misleading investors by hyping prospects for Winstar. The company, headed by William Rouhana, filed for bankruptcy in April, 2001.

Capital raised by Salomon

\$888 MILLION

Salomon’s fees:

\$6.3 MILLION

McLEODUSA

According to a lawsuit filed against Salomon, Grubman allegedly doled out shares of hot IPOs to executives to win investment banking business. One of the executives who allegedly benefited was Clark M. Leod, former CEO of McLeodUSA.

Capital raised by Salomon

\$3.4 BILLION

Salomon’s fees:

\$68.6 MILLION

financial statements. A spokesman for the company "supports the investigation and wants them to get to the bottom of things so we can all move forward," Qwest and Global Crossing have any wrongdoing. Global Crossing were not available for comment. A spokesman for Qwest

says, "We worked with [Grubman] as we would any analyst."

Grubman is under the microscope, too. Besides the NASD, he is being investigated by New York Attorney General Eliot Spitzer and U.S. Attorney James B. Comey in Manhattan. He was called before the House Committee on Financial Services on July 8 to explain his role in the WorldCom accounting scandal—and

was hammered by legislators. "We have an independent analyst who is neither independent and apparently can't analyze," said Michael E. Capuano (D-Mass.). "My major fear is that you'll get away with it." Salomon has supported Grubman, although Citigroup said in July that it would support a ban on analysts participating in many investment banking activities.

Grubman has defended his actions before Congress and elsewhere. He said that he helped Qwest, Global Crossing, WorldCom, and others raise billions of dollars because he saw a brilliant future for the telecom industry. He thought a rapid deployment of broadband connections to businesses and consumers around the country would lead to a surge in Internet traffic that would require the creation of new networks with vast amounts of capacity. He admits he was wrong in his analysis. But he says he was not motivated by conflicted interests. "I am saddened by the events that have brought us here," he told congressional probers on July 8. "I am sorry to see investors suffer losses. I am sorry to see employees laid off."

No question, the damage caused by Grubman and his circle of insiders is threatening to undermine the health of the telecom industry. While Grubman and his allies encouraged investors to cough up the billions of dollars needed to make huge new capital investments in fiber-optic networks and broadband connections, it's now clear that that vision of the future was wildly hyped. Billions in investments are going to waste, as little as 3% of new long-distance networks are being used, and investors are fleeing the sector. Even once-stable players are suffering. On July 23, local-phone giant BellSouth said WorldCom owes the company \$75 million to \$160 million, contributing to a 15% drop in BellSouth's stock price that day.

The crisis could relegate the U.S. to second-class status in the communications industry. In the 20th century, U.S. phone services were the envy of the world, reaching 95% of the population and operating with 99.999% reliability. They played a crucial role in the U.S.'s economic development and even served as a strategic asset in World War II, thanks to innovations such as early wireless communications. But in recent years, the rollout of high-speed Net access and other services has been led by other nations, such as South Korea and Japan. As telecom companies cut back on capital spending, it will be harder to catch up. "The U.S. is already behind, and will likely fall further behind as telecom com-

GLOBAL CROSSING

Salomon advised

Global Crossing on several purchases, including its failed bid for US West and its successful \$11 billion deal for Frontier in 1999. Global Crossing Chairman Gary Winnick reaped more than \$700 million from stock sales before the company filed for bankruptcy in January.

Capital raised by Salomon:

\$5.4 BILLION

Salomon's fees:

\$83.8 MILLION

QWEST

Grubman helped founder Philip

Anschutz recruit Joseph Nacchio as Qwest's CEO in 1997. Also, according to a lawsuit filed against Salomon, Grubman allegedly doled out shares of hot IPOs to several executives, including Nacchio, to win investment banking business. Anschutz sold \$1.9 billion in Qwest stock before its recent collapse. Nacchio pocketed more than \$248 million from stock sales before he was pushed out in June.

Capital raised by Salomon:

\$5.6 BILLION

Salomon's fees:

\$34.4 MILLION



NACCHIO



WINNICK

panies find it extremely difficult to raise funds in the near term," says James Glen of Economy.com.

Already, the fallout is brutal. The \$2 trillion in losses that telecom investors have suffered is twice the damage caused by the bursting of the Internet bubble and on a par with the savings- and loan crisis of the late 1980s. Bank exposure to the telecom mess is tens of billions of dollars. Worse, the investigations into WorldCom, Global Crossing, and Qwest, layered on top of the Enron scandal, are dealing a huge blow to investor confidence. They've led the entire stock market down as the Standard & Poor's 500-

stock index has tumbled 29% drop so far this year.

It wasn't supposed to turn out this way. The incestuous telecom players had a legitimate business idea: making the U.S. industry the most competitive in the world. Deregulation in 1996 allowed any company, including long-distance players such as AT&T and WorldCom, to move into the local telephone business and compete against the Bells. One of the first success stories was MFS Communications Co., which was started in the early 1990s by execs from construction giant Peter Kiewit & Sons in Omaha. MFS built local phone networks around the country. After WorldCom decided to

move into the local business it bought MFS for the then-unheard-of \$10 billion.

It was a windfall for everyone involved. Top MFS execs, such as Crowe and Royce J. Holland, made millions apiece. WorldCom's Salomon Smith Barney, reaped millions in fees. Even WorldCom rose, which is unusual for a company that plays the acquiring role in a takeover. But the company had a key supporter, Grubman, who endorsed the deal.

The temptation to keep using the formula was irresistible. MFS expected WorldCom to set up new telecom companies. Crowe created long-distance

BANKRUPTCY MIGHT WHIP WORLDCom INTO SHAPE

The announcement had been expected for weeks. On July 21, WorldCom Inc., the nation's No. 2 long-distance carrier and top carrier of Internet traffic, declared bankruptcy in New York. The company's decision to seek protection from its creditors amounts to the biggest Chapter 11 filing in U.S. history and marks an ignominious fall from grace for one of the tech boom's highest-flying players.

But the WorldCom story is far from over. Assuming its customers don't abandon it—and CEO John Sidgmore is working overtime to prevent that—the company looks likely to emerge from bankruptcy stronger than ever. The very idea is giving WorldCom's rivals palpitations. With most of its debt erased—and most of its assets intact—a post-bankruptcy WorldCom would be in a position to slash its prices and grab share, inflicting more pain on a sector already suffering from a vicious price war and overcapacity. "This is anything but positive for the industry," says Credit Suisse First Boston analyst Daniel P. Reingold.

Like many of WorldCom's rivals, he believes the industry would be better served by consolidation. Long-distance carriers and Baby Bells alike have eyed WorldCom's assets, and most would like to see the company split up and sold off.

But it's not up to the industry. What happens next will depend largely on WorldCom management and its bondholders, both of whom are expected to fight tooth and nail to keep the company together. While its lenders had the upper hand before WorldCom filed for bankruptcy, now the power has shifted

to the bondholders, say people close to the action. That's because they hold most of WorldCom's outstanding debt—\$29 billion to the banks' \$2.65 billion. Moreover, the bank loans were unsecured, which puts lenders in the same category as suppliers—near the back of the queue. "Lenders will get a few seats for appearances' sake, but the bondholders will call the shots," says an

debt-equity swap, since gaining a healthy, ongoing business with a clean balance sheet is their priority. Getting any of their money back will dominate the creditors' agenda, although the lenders and vendors will be appeased, and they won't be.

Moreover, the process could be derailed by the discovery of new accounting irregularities, which

CEO SIDGMORE

If he can keep customers from fleeing, a debt-free WorldCom could inflict serious damage on its competitors



attorney representing one of them.

That's how it looks now, although things could change as the bankruptcy goes forward. As it stands, WorldCom officially has 120 days to negotiate a reorganization plan with bondholders, banks, and other creditors. But the process is expected to take a minimum of nine months because dozens of different parties—bondholders, lenders, and vendors—are angling to retrieve a total of \$41 billion. The bondholders favor a

prompt creditors to demand that a judge replace company negotiators with an independent trustee. Already, creditors are pushing hard to oust Sidgmore for the moment his job is on the line thanks to strong support from the board of directors. "It's not that I think Sidgmore has done anything wrong," says a creditor. "We just want a fresh start, someone not associated with the current mess."

So what is likely to be hived

Level 3 Communications Inc., Alland created local-service com- Allegiance Telecom Inc., both of received funding from Salomon following recommendations from an. "These guys decided they all jump on the Net bandwagon. were all trying to tap markets as as possible before others jumped " says telecom analyst Glenn Wal- UBS Warburg. bman and the telecom execs ar- hat the market could easily ab- all the new capacity. At one road after another, from the meeting of San Jose, Calif., to the dining of plush Manhattan hotels, Crowe

stood before audiences, charming them with the bearing and voice of a senior military official. He argued that the telecom sector was going through the same sort of changes that had spawned successful startups in the software and computer industries. He said that "Silicon economics" would allow upstarts such as Level 3 to offer more capacity at lower prices than mature rivals such as AT&T. And the demand for these networks would soar as voice communications gave way to e-mail, pictures, video—even holograms, Crowe said. Investors ate it up, and the shares of these companies soared.

Before long, the line of entrepreneurs waiting for funding stretched out the

door. Salomon funded upstarts Qwest, Global Crossing, Teligent, Winstar, Rhythm, Williams Communications, Focal, and dozens more. "WorldCom delivered such success that Grubman had [other telecom executives] mimic [WorldCom's approach]," Kalla says. "He would put them up on the pulpit at his conferences, where they were the keynotes. It was just very well orchestrated."

Meantime, Grubman was becoming a star. He rose from humble roots—his father was a construction manager for the city of Philadelphia, and his mother worked in a dress shop. A math whiz, he worked at AT&T from 1977 to 1985, doing quantitative research, among other

The various parties are like- to sell off such unprofitable s wireless resale and SkyTel g businesses. However, the d its bondholders are ex- ight mightily to hang on to assets: worldwide data net- T, WorldCom's corporate- ce business, and consumer- ce company MCI Group. s revenue is expected to fall al 15% to \$8.3 billion this ompany still accounts for 24% om's revenue. WorldCom

are expected to be up 5% to 10% over- all next year, with international busi- ness surging the most, up 14%, accord- ing to Reingold. That's made UUNET, with sales of \$4.7 billion, the most promising part of the company. Execu- tives and the bondholders believe a re- vitalized WorldCom could be built around MCI and UUNET.

Key to their strategy, of course, is convincing WorldCom customers to stay the course. Big corporations don't like switching data or long-distance carriers because of the potential disruption to

Com's longtime vice-president of gov- ernment markets. "Every day it gets harder to win a new government con- tract." If the departures become an ex- odus that could mean big trouble. Friedman, Billing, Ramsey Inc. analyst Susan Kalla calculates that WorldCom could withstand no more than an 8% drop in revenue from departing cus- tomers. Much more, and "they'd be toast for sure," she says.

That explains why Sidgmore and oth- er top execs are each making reassuring calls to up to 20 corporate customers a day. Company salesmen also remain on the offensive. They're offering customers as much as \$30,000 as a signing bonus to stay on, according to Sprint and AT&T. And they're matching whatever terms those two rivals are offering. The blitzkrieg seems to be working so far. Sprint and AT&T execs say they haven't yet managed to shake loose any of WorldCom's prize customers.

If WorldCom retains its customer base and manages to emerge from bankruptcy intact, its prospects are ex- cellent, say analysts. Not only would it be virtually debt-free, but by then the company would have shed tens of thou- sands of jobs, thanks to pre-bankruptcy cuts and the sale or dismantling of some unprofitable units. Moreover, as part of the restructuring, WorldCom says it will shut down underutilized networks, saving millions in operating expenses. And because the company won't be adding capacity, it will be able to cut capital expenditures from \$2.5 billion today, to some \$500 million. The result: one mean, lean competitor. First, though, WorldCom must get through the bankruptcy in one piece.

By Charles Haddad in Atlanta, with Roger O. Crockett in Chicago and Heather Timmons in New York

After Chapter 11

Why WorldCom could emerge intact

NO BUYERS Would-be acquirers of such key assets as MCI and UUNET fear they would be liable should the government file criminal charges against WorldCom

LOYAL CUSTOMERS WorldCom is likely to keep its customers—at least for the time being—because switching carriers would be costly and possibly messy

POSITIVE CASH FLOW The bankruptcy filing frees WorldCom from repaying more than \$11 billion in debt principal and interest payments coming due in the next three years, which should greatly boost its cash flow

MARKET POWER Many analysts believe WorldCom will be able to price aggressively and grab market share once it hives off most of its debt

keep MCI because it's a cash ny likely buyer would yank stance traffic from World- work. part, UUNET represents 30% s. Internet traffic. The likes of Warner, Nasdaq, and FedEx UUNET for everything from ivate networks to Web hosting et access. While growth has arply since the boom years of 90s, data and Internet services

their operations. Still, some are clearly spooked. Apple Computer, CNET Net- works, and Logitech have all shifted some of their business from WorldCom to Sprint and AT&T. Says Sprint Corp. CEO William T. Esrey: "We're picking up substantial business—literally daily." And WorldCom recently lost out on a multibillion-dollar contract to revamp the federal flight control system. "It feels like we're getting kicked in the gut," says Jerry A. Edgerton, World-

things, and then jumped to Wall Street. But it was moving to Salomon in 1994 that gave him the chance to become the most powerful analyst in his field.

His formula for his success was to grow increasingly close to the managers at the telecom companies he was covering. He recruited execs, helped plot strategy, and advised on mergers. For example, he helped Ebbers launch WorldCom's hostile bid for MCI in 1998, which resulted in the \$43 billion acquisition. In his

would hit \$11 billion by 2007. Grubman maintained a buy rating on the company—right until it declared bankruptcy in January of this year with \$1.8 billion in revenue.

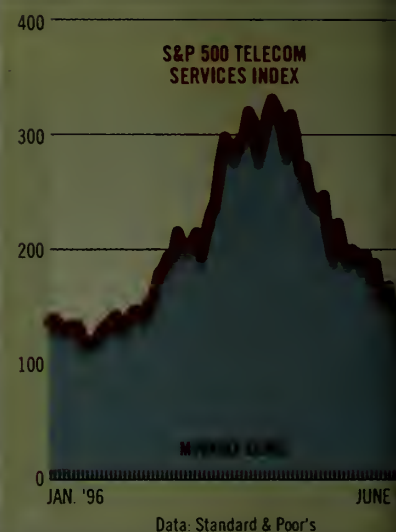
At first, no one ever worried about whether these telecom upstarts were making money. Even older telecom players, such as MCI and Sprint, needed years to invest in their network. MCI didn't turn profitable for more than a decade. When Grubman helped them raise money

Crossing and other carriers, bought \$450 million worth from Crossing and other carriers. That Qwest's revenue rise 12% for the half of the year. Without those Qwest revenue would have increased only 7%.

Such deals may have allowed management to cash out before the bubble finally burst. In May of last year, Winnick sold \$123 million worth of Crossing stock. That same



Telecom's Rise and Fall



DEEP HOLE Telecom investors' \$2 trillion in losses is twice that from the Internet plunge and on par with the S&L crisis of the late 1980s

congressional testimony on WorldCom, Grubman revealed that he had attended "two or three" board meetings at WorldCom at the company's headquarters in Mississippi. Rival analysts chafed at Grubman's chumminess with the execs he was covering. "He'd get on a company's conference call and just start talking about what he thought about the company," says one analyst. "We all had questions for the company, and he was asking them 'so, how about that dinner last night, huh?'"

The relationships in Grubman's network go back years. Clark McLeod sold his long-distance upstart to MCI in 1990 for \$1.25 billion, pocketing \$50 million. Then, in the mid-1990s, Grubman and the bankers at Salomon helped him launch a new company called McLeod Communications, raising \$3.4 billion for construction of a 31,000-mile telephone network. McLeod, a Midwesterner who handed employees copies of his book *This Way Up*, boldly promised that revenues

in the late 1990s, the Internet bubble was in full swing, and claims that rising data traffic would allow them to become profitable someday sounded believable. The unspoken assumption was that they would be acquired anyway by the likes of WorldCom, AT&T, or one of the Bells.

These assumptions were shaken when the Internet bubble burst in March, 2000. As one dot-com after another went bust, the growth of data traffic slowed. Network utilization on all the new optical telecom networks fell to just 3%, and prices started plunging 50% a year. The capital windows quickly slammed shut.

Telecom executives realized that they could never deliver on their promises of revenue growth of 20% or more. But rather than come clean to investors, an alarming number of them resorted to misleading accounting practices to preserve the illusion of stability. In the first six months of 2001, Qwest sold \$857 million worth of network capacity to Global

Anschutz sold \$230 million worth of Qwest stock. The SEC is investigating both companies.

With investors losing trillions of dollars and dozens of telecom players in bankruptcy, there are growing calls for action against those responsible. Grubman, certainly, will face more scrutiny. New York Attorney General Spitzer subpoenaed his research records, e-mails, and other documents. If Spitzer finds wrongdoing, Salomon may have to pay a fine or even discipline Grubman. U.S. Attorney's investigation could also result in criminal charges.

Two years ago, Grubman claimed he was creating a new model for Wall Street analysts. Today, it's a model that Grubman—and most telecom investors—wish they had never heard of.

By Steven Rosenbush in New York with Heather Timmons in New York, Roger O. Crockett in Chicago, Christopher Palmeri in Los Angeles, and Charles Haddad in Atlanta

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CITI'S SLEEPLESS NIGHTS

The bank faces lawsuits, fines, and closer scrutiny

As Citigroup's stock price plummeted 10% on July 22, Prince Alwaleed bin Talal, the Saudi Arabian royal who is the bank's largest shareholder, called Sanford I. Weill, Chief Executive Weill seemed to be taking the drop, which sliced \$15 billion off Citi's market cap, in stride. "I guess you and I have both lost a little money this last week, your Highness," he joked. Alwaleed was less sanguine. "I think Sandy has to clarify the situation of Citibank much more aggressively," he told *BusinessWeek*.

Citigroup is facing its most serious crisis since Weill created the financial behemoth in 1998. Jack Grubman, the influential telecom analyst at Salomon Smith Barney, Citi's investment bank, is under investigation by the National Association of Securities Dealers and the New York State Attorney General's office. Salomon is also being sued over billions worth of bonds it underwrote for Enron Corp. and WorldCom Inc. Citi's corporate bank is accused by a Senate committee of using sham transactions to help Enron deceive investors. Its consumer bank is being grilled by the Federal Reserve over its subprime lending practices. And tough-minded banking regulators may wield widened powers to impose hefty debt write-downs and provisions on Citi.

There's no evidence the 69-year old Weill's position is in question. Alwaleed, who owns 6% of the stock, says he is "confident" that Weill will prevail. But a few former senior executives say the competitive culture that Weill has fostered inside the bank may be backfiring as investigators scrutinize the bank. At Citi, says one, employees "are expected to take risks—to produce handsome profits for which they will be rewarded. If not, they're gone." But a Citigroup spokeswoman rejects any implication that the culture encourages reckless behavior. "Sandy demands results, the first

of which is maintaining and building the integrity of the firm," she says.

However, the bank, the U.S.'s biggest with nearly \$1 trillion in assets, faces a potential triple whammy of big payouts over lawsuits, stiff fines imposed by regulators and legal authorities, and a regulatory crackdown. Some analysts speculate the sea of problems could now make it much more difficult for Weill to do what he loves best—dealmaking. Citi's pending acquisition of Golden State Bancorp, a key in its expansion in retail banking, "might be hung up," says David Hendler, an analyst with Credit Sights. "Regulators may feel that Citigroup has to slow down and apply better risk management, rather than continuing to build their empire." A Citigroup spokeswoman says, "The bank has every expectation the deal will close as planned."

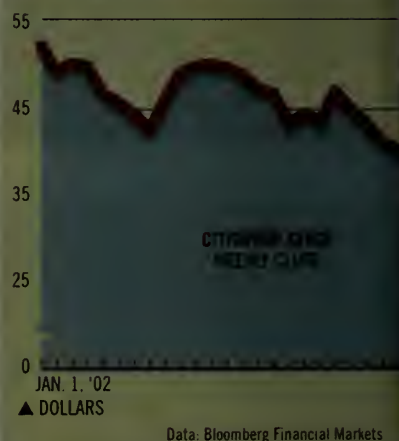
Delays in getting regulatory clearance would be a severe blow to Citigroup. It has built a reputation as a powerhouse, in part because of its successful acquisitions. Salomon Smith Barney, which Weill put together over years, is now the premier underwriter of global debt and equity and rakes in far more banking fees than rivals. As it built up its underwriting prowess, Salomon was helped by Grubman's role as the Pied Piper of telecom.

Now, the NASD is investigating Grubman's coverage of Winstar Communications, and has made a "preliminary determination" that violations occurred. On July 24, Rep. Paul E. Kanjorski (D-Pa.) requested the House Committee of Financial Services to subpoena Salomon for information on initial public offering allocation to WorldCom executives. So far the bank is behind Grubman. But it has also adopted some reforms designed to keep analysts and bankers separate.

More serious damage could come from Citigroup's links with Enron. On

CEO SANDY WEILL
IS FACING CRISIS
AT CITI

Bailing Out



July 23, Carl Levin (D-Mich.), chair of the Senate Permanent Subcommittee on Investigations, said that "corp knew what Enron was doing, assisted Enron in the deceptions, profited from their actions." At issue: \$4.8 billion in transactions that Citigroup arranged for Enron. The findings known as pre-pays were really disguised bank loans that helped Enron make its numbers, the committee

SILVER LINING "This is not only the most profitable bank in the wor

A Raft of Woes

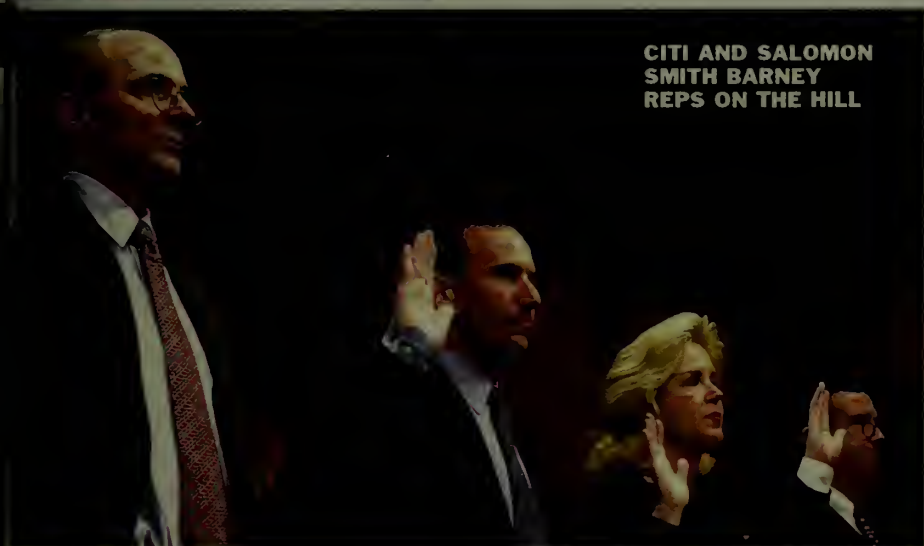
ENRON Senate investigators allege \$4.8 billion in Citi transactions with Enron are "shams" and that the bank knowingly assisted the energy company in deceiving investors and the public; pension holders are suing Citi and others.

WORLD.COM Bondholders' suit alleges Citi and other banks didn't do proper due diligence before selling \$11 billion worth of WorldCom bonds.

JACK GRUBMAN Salomon Smith Barney analyst faces investigations by the New York State Attorney General and NASD into securities violations. Congress may subpoena Salomon about alleged improper initial public offering allocations to executives with banking clients.

CONSUMER LENDING Federal Reserve is questioning CitiFinancial practices in subprime lending; new regulatory guidelines could crimp profits in Citi's massive credit-card unit.

Data: Congressional and government reports, court documents



CITI AND SALOMON SMITH BARNEY REPS ON THE HILL

s. If both the Citi deals and similar transactions by J.P. Morgan Chase & Co. had been put on Enron's balance sheet, its debt ratio would have soared 6.2% from 69.2%.

Citigroup's liability could hinge on whether it knew it was doing something wrong. David Bushnell, managing director at Citigroup's Global Corporate & Investment Bank, defended the transactions. "We believed that En-

ron was making good-faith accounting judgments that were reviewed by Arthur Andersen, which was then the world's premier auditing firm in this sector," said Bushnell. "Enron was not the company we thought it was." But one e-mail obtained by investigators seems to indicate that bankers panicked when an investor started asking questions about one such transaction, saying "We need to shut this down."

New guidance from regulators could cut earnings at Citi's consumer-lending arm, its most profitable unit this year. On July 22, regulators warned banks—especially those heavily into subprime, or high-risk, credit-card lending—to tighten their procedures, create larger reserves, and manage risk better. Citigroup has the largest card portfolio in the world, with 108 million accounts.

Equally threatening to Citi is a torrent of litigation. Bondholders who bought more than \$11 billion in WorldCom debt last May are suing underwriters Citigroup and J.P. Morgan for lack of due diligence. WorldCom said in June that it had found a \$3.8 billion accounting fraud. Both banks say their underwriting was proper. But plaintiffs' lawyers may have a case. In a 1968 ruling, *Escott v. BarChris Construction Corp.*, a judge said that bond underwriters should have known BarChris was faking some numbers because internal documents showed the company was having trouble getting customers to pay on time. Citi is already named in Enron-related suits brought by pension holders. They could be followed by insurers, which bought securities designed by Citi, to hedge \$1.4 billion of its Enron exposure.

Now the Gramm-Leach-Bliley Act of 1999, which repealed the Depression-era prohibition against combining commercial and investment banking—and was tailor-made for Citi—could be used against the bank. The law requires diversified financial companies to be "well-managed," not just "well-capitalized." On July 18, federal regulators are limiting the activities of Pittsburgh's PNC Financial Services on those grounds. Institutions most at risk of scrutiny are those involved in complicated financing such as special purpose entities and pre-pay deals, both of which Citi arranged for Enron, says Karen Shaw Petrou, managing partner of Federal Financial Analytics Inc., a Washington bank consultancy.

Despite Citi's problems, Alwaleed sees a silver lining. "This is not only the most profitable bank in the world, but it is now the cheapest," he says. That's fine—provided the heavy discount on the stock isn't a warning of worse to come.

By Heather Timmons in New York, with Laura Cohn and Mike McNamee in Washington, and John Rossant in Paris

it's the cheapest," says Citibank shareholder Prince Alwaleed

ACCOUNTING

THE NEW PINCH FROM PENSIONS

Companies must pour billions into retiree plans after betting on stocks

Amid the wreckage of the worst bear market in at least three decades, hemorrhaging corporate pension plans are rapidly becoming Wall Street's biggest new worry. They have lost hundreds of billions of dollars, and now companies face the end of their long-running holiday from writing checks to the plans. Over the next 18 months or so, companies ranging from General Motors to United Technologies face having to pump billions into their plans to comply with federal laws to protect pensioners.

Even if plan investments somehow manage to eke out 5% returns this year, companies in Standard & Poor's 500-stock index will be \$40 billion short of their projected pension obligations, according to Morgan Stanley estimates. If plans lose 5%, they'll be \$150 billion in the hole. Either way, it is a world away from 1999 when the plans had a \$292 billion surplus and a 30% cushion over their commitments. "The squeeze on U.S. pension funds has the potential to be the defining U.S. financial crisis of the 2000s, like the savings and loan squeeze of the 1980s," says Bob Prince, director of research and trading at money manager Bridgewater Associates.

The economic consequences of the squeeze could extend far and wide. Cash

that companies earmarked for buying new equipment, expanding markets, hiring employees, buying back stock, or repaying debt will have to be used to shore up pension plans. The shift will be another downer for stock prices, cutting out spending that used to boost growth in earnings per share. And the impact will soon be felt.

Under government rules, some companies must start making up for 2001 shortfalls by the end of this year. For others, the bites will start in 2003 or 2004. "Some companies are going to be contributing for the first time in 10 years," says John Ehrhardt, a principal and consulting actuary at Milliman USA Inc. "In thinking about capital expenditures, there is a new party at the table, the pension plan."

Old-line companies or those with large unionized workforces will be particularly hard hit because they have large defined-benefit plans—ones offering guaranteed payouts to pensioners. The biggest obligations are among auto, telephone, airline, steel, chemical, and pharmaceutical companies. For example, if plans lose 5%, United Technologies could have to cough up \$1.4 billion in 2003, Delphi \$1 billion, and AMR \$415 million, according to the Morgan Stanley estimates. The companies say they're step-

ping up infusions sharply, but they'll need to put in as much as some estimates. United Technologies Corp. says it recently contributed 1 million worth of its own stock to its pension plans. Delphi Corp. says it is putting in at least \$200 million a year for the next five years, but concedes that will not be enough if its investments don't appreciate at 10% a year. AMR Corp., parent of American Airlines, says it intends to make larger contributions than in the past, but won't say how much. General Electric Corp., which has the biggest pension plan of all, with \$80 billion in obligations disclosed July 16 that it expects to contribute \$9 billion into its plans by 2007.

How did companies paint themselves into such a corner? It was more bad luck. They made a bold bet in the 1990s that stock prices and interest rates would move in opposite directions as they have nearly every year since the Great Depression. The relationship is crucial to pension funds because when interest rates go down, government bonds require the plans to have large pools of investments to meet future obligations. That can only happen if interest rates rise or companies put more money into the funds.

For years, the tactic worked well. But as fund assets went up





liabilities increased. Companies became confident about putting more of their pension assets into stocks than in the past. The resulting investment gains in the bull market more than covered most of the payouts they made to retiring employees, averaging about 7% of the funds' total values. Better yet, accounting rules allowed companies, quite often, to boost their reported earnings by selling assets with higher projected future gains because they were holding more stocks. Some, again quite often, were able to actually tap the pension assets to help pay retiree medical costs and even merger consolidation costs.

But, however, the bet has turned sour. Stocks—in which a record 60% of pension assets were invested in early 2000—have gone down in the bear market, and interest rates. The result: pension assets have plunged at the same time that their liabilities have soared. The net result has wiped out the gains racked up during the long bull market, and then some.

The reversal has been fast and furious. As recently as 1999, nearly 78% of the assets at S&P 500 companies had surplus. But by the end of this year, less than 26% will have one. And workplace pension graphics are making matters

worse. With average lifespans lengthening, more plan beneficiaries are retiring than dying. So cash to pay benefits is draining out of the weakened funds as never before. Besides, the funds are dwindling as new workers are put into defined-contribution plans such as 401(k)s, in which employees, not the company, take all the investment risks.

With impending cash calls, the stock market is getting a double whammy from corporate pension plans. The first battering came late last year when investors realized companies had inflated their reported earnings by exploiting loopholes in accounting rules. By making overly optimistic assumptions about future investment returns, companies were able to puff up earnings by some 10% even though the maneuver generated no new cash. Now, investors are being sideswiped again. This time, reported earnings aren't affected even though real cash exits the pension plans.

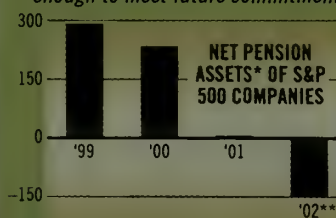
The fear is that nobody but the companies knows exactly

how big the cash calls will be. Companies hardly ever disclose anything in their Securities & Exchange Commission filings about the impact of the government pension rules on them. "The specific calculations are impossible to get right with publicly available data," says Trevor S. Harris, accounting analyst at Morgan Stanley. That is important because it means investors can't accurately predict corporate cash flows. Milliman's Ehrhardt, who helps companies navigate funding rules, says many companies know more about the coming cash calls than they have been telling. For investors' sake, "opening up the book on funding strategy is where companies should be going," he says.

Some companies may have reasons for not showing their cards. Ehrhardt says many that have cash on hand are putting more money into their plans even when the government rules don't require it. One big appeal: Executives get to figure the additional assets into their estimated investment re-

THE SURPLUS VANISHES

Three years into a bear market, once-flush corporate pension plans are no longer big enough to meet future commitments



▲ BILLIONS
*ASSETS LESS OBLIGATIONS
**ESTIMATE: ASSUMES 5% LOSS ON INVESTMENTS
Data: Morgan Stanley

turns in their reported earnings. If they are estimating 10% investment returns, a \$100 million contribution will boost operating income by \$10 million, which is more than many believe they can earn elsewhere right now. Also, they can often get tax deductions for the payments. And thanks to a recent change in tax law, they can sometimes contribute to overfunded plans without suffering penalties.

Meantime, by making estimates based on the numbers companies do report, Harris and other analysts are scoping out the ailment and the most seriously diseased companies. For example, Harris figures that if the Delphi plan's investments end this year with even a 5% loss, its remaining assets will be enough to fund just 65% of its \$8.4 billion in obligations. Besides the \$600 million Delphi should put in this year, government rules suggest it would need to put in an additional \$1 billion next year.

John G. Blahnik, treasurer at Delphi, says the company is being "open and frank" in earnings conference calls about the cash needs of its pension plans. But like most companies, Delphi is presenting its assessments on its own terms, without regularly reporting all the assumptions that go into its estimates. Blahnik says Delphi recently doubled its contributions to the plans, to \$400 million this year, to try to get it back on track. Assuming the plan's assets earn 10% a year, he intends to put in at least \$200 million, taking advantage of some extra time Delphi earned under government rules for contributions made in the past.

Worries about pension plans sucking cash out of companies are increasingly catching Wall Street's attention. They were a factor in the downgrade of GM's

credit rating last fall by Standard & Poor's, and they are in part to blame for its stock falling 34% since mid-May. GM's forecasted \$9 billion in makeup payments through 2007 compare with \$3.6 billion in cash flow the company is expected to generate this year after dividends, interest, and capital expenditures. To help fund a \$2.2 billion payment this year, the company sold convertible debt in April. GM may have to repeat that operation in the future. "We're going to have to put in more cash than we planned," says Vice-Chairman and Chief Financial Officer John M. Devine.

"All companies are going to have to look at their pension plans," warns

Patrick D. Campbell, CFO of a company hasn't decided yet to pony up, but he does with Harris' estimates that a contribution will be needed in 2003 if assets lose 5% this year. The company's U.S. and foreign plan are 11% short of projected obligations at the end of 2001, according to the company's annual report. And since U.S. stocks have fallen and "Obviously, we're going to have to get through this," says Campbell.

At Raytheon Co., CFO Frank Caine says he is preparing contingency plans for its funds. He had expected assets to earn 9.5% this year, but

he figures that if the fund suffers a 5% loss, Raytheon will have to contribute an extra \$85 million in 2004. If the fund loses 10%, he will have to find another \$189 million in 2004.

Last year, Maytag made its first payment in 10 years to its plans, \$100 million, says CFO Steve Wood. This year and next, it will put in \$100 million as it tries to make up for the poor market performance for an increase in contributions won by its labor union. "We think it is probably going to contribute to the plan," says Wood. But it cedes the money to the well spent paying off debt, Maytag's other priority. During the bull market, available money went toward stock buybacks, though the plan is slightly underfunded.

Investors will probably wish for a long time. Maytag and other companies still had the luxury of not tending to their pension plans. The complexity of funding rules, fill in the various triggers, lowances, and acceleration payment requirements add uncertainty to rate cash flows for years to come. More complex last things that battle investors want.

By David Henry
New York, with David W. Smith in Detroit, Michael A. Leary in Chicago, and Amy L. in Philadelphia

Give and Take

Under government rules, many companies will have to put cash into pension plans depleted by market losses

The cash drain starts this year...

COMPANY	ESTIMATED 2002 CASH NEEDS	ANNOUNCED INFUSIONS
GENERAL MOTORS	\$1,993 million	\$2,200 million
DELPHI	592	400
US AIRWAYS	703	none
AMR	314	amount pending
PHARMACIA	234	as much as 60

...but will really hurt next year

COMPANY	ESTIMATED 2003 CASH NEEDS IF 2002 INVESTMENT RETURNS ARE:	
	PLUS 5%	MINUS 5%
GENERAL MOTORS	\$3,051 million	\$4,507 million
UNITED TECHNOLOGIES	795	1,372
FORO	0	1,183
DELPHI	690	1,016
US AIRWAYS	697	798
PFIZER	456	784
RAYTHEON	467	680
GOODYEAR	393	590
CHEVRONTXACO	287	516
EXELON	325	458
AMR	295	415
3M	0	378
PHARMACIA	238	341

Data: Morgan Stanley, BusinessWeek

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for any individual
to have a computer
in their home."

1977

"Portal,
schmortal."

2002

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COMMENTARY

By John Rossant

FREE MARKETS IN EUROPE: A TOUGHER SELL THAN EVER

to most Americans, the headline on the front page of France's leftist daily, *Libération*, on July 23 could be anything but funny. "Faut-il aller à la Bourse?" the newspaper asked. Loose translation: "Should we go down the stock exchange?" That headline ran in the midst of a losing streak that has shaved 40% off the Paris Bourse in just eight weeks, a steepening plunge the French have rarely experienced. No wonder the question posed by the paper showed certain Gallic hostility to the market—a hostility Americans haven't known in years.

Libération was joking, of course. But jokes have a way of getting at deeper truths, and this one is dark indeed. Over the last 10 years or so, Europe has moved ever closer to what it calls the Anglo-Saxon model, with its accent on equity markets, deregulation, and privatizations. And a huge surge of transatlantic investment in the past decade intertwined the fates of European and U.S. companies more tightly than ever. But Americans and Europeans both know that antismarket sentiments still run deep across the Continent. Just look at the recent general strikes in Spain and Italy over relatively minor changes in labor laws. Now we seem to have the ultimate capitalist debate, a disaster sure to arouse the ire of the European Left. If the meltdown leads Europeans to reject the U.S. model, then Americans would lose their biggest free-market partner.

The Great Slo-Mo crash of 2002 definitely complicates the use of free-market capitalism in Europe. But it won't end it, for the simple reason that Europeans need the markets as much as Americans do, and they've gone too far down the liberalizing path to turn back.

Without a doubt, in-

dividual Europeans are frightened by collapsing stock markets—even if, as France's new Finance Minister Francis Mer points out, the low level of stock ownership in Europe means the macroeconomic fallout of the crash will be more limited than in the U.S. "I bought Deutsche Telekom shares

and then invested in a mutual fund," says Heidi Wagener, a 52-year-old hotel owner from Frankfurt. "I expected to make money but I've ended up losing it. Of course, I'm disillusioned." Meanwhile, the rise in bankruptcies and bad debts has killed hopes that the corporate bond market would take off anytime soon. And plans to privatize pensions are hampered or delayed. "The crash makes it harder to convince the unions and ordinary people that private pensions are the right solution," says Noël Goutard, chairman of Paris-based autoparts giant Valeo.

Yet the American model will still play a role in Europe. What, after all, could Europe go back to? The Left, though it can still field demon-

strators, has been sapped of its strength. Communist parties have collapsed in Western Europe. And Socialist-led regimes have been voted out, first in Italy, then in France, and soon, most likely in Germany.

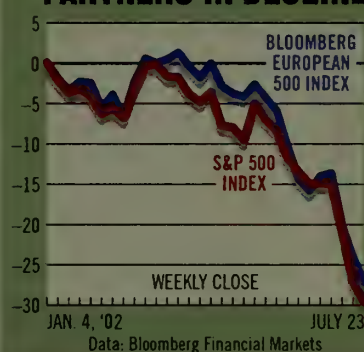
Besides, while individual investors are turned off, Europe's governments, whatever their political coloration, are totally hooked on the markets. Governments raised billions by selling stakes in telecoms and other giant companies. The politicians have spent that money, and now need to privatize more assets. They cannot borrow

much more or hike taxes further. The privatized telcos, meanwhile, are loaded with debt—assumed partly to buy new mobile licenses from the government—and need to raise new equity.

One way or another, Europe's governments and big companies must stick with the American model. What could help? If U.S.-style capitalism becomes more palatable by turning more—well, European. Americans are talking about reducing the effect of options, and of knocking CEOs off their pedestals. Sounds right to the Europeans. Says Jürgen Kluge, Dusseldorf-based director of McKinsey & Co.: "Our model now looks good: the boring CEO whose compensation is not linked to share price gains so the possibility of fraud is not big." A dose of humility among free-market advocates could do wonders for the cause in Europe. That's important, because in the Old World, that cause is damaged, not lost.

With David Fairlamb

PARTNERS IN DECLINE



A FRANKFURT TRADER REACTS TO PLUNGING STOCKS



CORPORATE PROFITS

WAITING OUT THE EARNINGS RECESSION

Profits are mostly up for now, but flat sales could hurt

By now, the verdict is virtually unanimous: The economic recession ended last fall. So the end of the earnings recession can't be far behind. Right? Well, it's not that simple, based on *BusinessWeek's* flash-profit survey of second-quarter results. Depressed by a \$13.1 billion write-off at AT&T and immense losses at other telecom companies, net income at the 125 businesses in the sample is down 30% from a year earlier, while sales are flat.

Fortunately, the profits picture looks brighter after factoring out telecom. Without the poor performance of just two companies—AT&T and Lucent Technologies Inc., which lost \$7.9 billion—flash profits would have risen 14%, while sales would have been up 1%.

Indeed, of the 125 companies, fully 84 showed improved earnings over a year ago. Clearly, many are rebounding. General Electric and Citigroup—despite its many recent problems—both topped the \$4 billion mark in earnings, with profits up 14% and 12% respectively. Philip Morris Cos. also boasted a 14% gain, to \$2.6 billion, and Microsoft's income soared to \$1.5 billion from just \$65 million in 2001, when earnings were swamped by charges. Ford Motor, meantime, swung to a \$570 million profit from a \$752 million loss, and at General Motors, net income nearly tripled, to \$1.3 billion.

Still, the overall outlook remains quite mixed. Most disturbing is the anemic trend in overall sales, which could hold ominous implications for the recovery. If revenues remain sluggish, further profits gains will have to come through continued cost-cutting and layoffs.

The earnings retreat is not limited to telecom. Falling oil and gas prices battered the five oil companies on the list, resulting in a collective 56% percent decline in profits. Conoco Inc.'s 76% drop was the worst. Many tech giants also stumbled. IBM's income plummeted 79%, to \$445 million, because of write-offs and an unprecedented slump in its services business. While still profitable, Big Pharma also slipped, hurt by new competition from generic drugs and delays in product launches. Bristol-Myers Squibb Co. said its net plunged 60%, to \$440 million, as sales slid 14%.

Airlines also continued to lose a bundle. For the top eight carriers reporting so far, losses were a combined \$1.4 billion, with only Southwest Airlines Co. scoring a profit.

What's more, many businesses warn that a turnaround may be far off. "It's a confidence issue out there right now as to when the economy is going to turn," notes James W. Anderson, investor relations director at

Caterpillar Inc., which said its second-quarter earnings fell 26%, to \$200 million.

Of course, flash profits are an early read: The picture can change once all companies report. Analysts polled by Thomson Financial/First Call still predict that profits will climb 14% in the third quarter and 26% in the fourth, although that estimate has already been scaled back and is likely to be trimmed further. With the economy still wavering and accounting questions still hanging over many corporate reports, the question of whether the long-awaited profits recovery has arrived remains open.

By Michael Arndt in Chicago and Frederick F. Jespersen in New York



CURRENT
(MILL)

INDUSTRIALS

374,02

ABBOTT LABORATORIES	4,31
ALCOA	5,24
ARCHER DANIELS MIDLAND ††	7,06
ASHLAND ††	2,05
AVON PRODUCTS	1,52

BOEING	13,85
BRISTOL-MYERS SQUIBB	4,05
BURLINGTON NORTHERN SANTA FE	2,20
CATERPILLAR	5,29
CENTEX †	1,84

COCA-COLA	5,36
CONAGRA FOODS †††	6,41
CONOCO	7,66
CROWN CORK & SEAL	1,78
DELPHI	7,32

DUPONT	6,70
FORD MOTOR	42,33
GENERAL ELECTRIC	33,12
GENERAL MOTORS	48,26
GEORGIA-PACIFIC	6,22

GILLETTE	2,02
GOODYEAR TIRE & RUBBER	3,47
HALLIBURTON	3,23
HARLEY-DAVIDSON	1,06
HONEYWELL INTERNATIONAL	5,65

ILLINOIS TOOL WORKS	2,434
INGERSOLL-RAND	2,587
INTERNATIONAL PAPER	6,309
JOHNSON & JOHNSON	9,073
KB HOME	1,139

KRAFT FOODS	7,513
LILLY (ELI)	2,775
LOCKHEED MARTIN	6,290
MAYTAG	1,193
MERCK	12,809

NIKE ††	2,682
NORTHROP GRUMMAN	4,396
NUCOR	1,141
OCCIDENTAL PETROLEUM	3,141
PEPSICO	6,178

PFIZER	8,033
PHILIP MORRIS	16,520
PHILLIPS PETROLEUM	10,367
R.J. REYNOLDS TOBACCO HOLDINGS	1,705
RAYTHEON	4,095

SCHLUMBERGER	3,388
TEMPLE-INLAND	1,202
3M	4,161
TYCO INTERNATIONAL ††	9,123
UNITED TECHNOLOGIES	7,324

UNOCAL	1,356
VF	1,193
VISTEON	5,039
WHIRLPOOL	2,737

SERVICES

188,63

ALLSTATE	7,455
AMERICAN EXPRESS	5,945
AMR	4,479
BANK OF AMERICA	N/A
BANK ONE	N/A

BEST BUY †	4,586
CAPITAL ONE FINANCIAL	2,369
CENDANT	3,784
CIRCUIT CITY GROUP †	2,118
CITIGROUP	26,938

	EST. EPS (5/15)	REPORTED EPS	DIFF.		CURRENT QTR. SALES (MILLIONS)	% CHG.	QTR. PROFITS (MILLIONS)	% CHG.	EST. EPS (5/15)	REPORTED EPS	DIFF.
5	0.54	0.51	-0.03	COSTCO WHOLESALE ††	8,616.7	+12	130.4	+24	0.27	0.28	+0.01
2	0.53	0.38	-0.15	DOW JONES	417.0	-14	54.0	+25	0.28	0.64	+0.36
4	0.32	0.27	-0.05	FEDEX †††	5,416.0	+6	236.0	+109	0.76	0.78	+0.02
10	0.18	0.17	-0.01	FLEETBOSTON FINANCIAL	NA	NA	-106.0	NM	0.72	-0.11	-0.83
7	1.36	0.93	-0.43	GANNETT	1,624.3	0	303.9	+30	1.12	1.13	+0.01
2	0.63	0.64	+0.01	GOLDMAN SACHS GROUP	6,234.0	-24	563.0	-2	0.99	1.06	+0.07
7	0.84	0.96	+0.12	HCA	4,903.0	+10	350.0	+33	0.62	0.66	+0.04
0	0.30	0.23	-0.07	J.P. MORGAN CHASE	NA	NA	1,028.0	+172	0.65	0.50	-0.15
1	0.47	0.51	+0.04	LEHMAN BROTHERS HOLDINGS	4,347.0	-31	296.0	-31	1.07	1.08	+0.01
6	0.71	0.58	-0.13	MANPOWER	2,602.9	-1	25.7	-26	0.24	0.33	+0.09
7	1.26	1.38	+0.12	MARRIOTT INTERNATIONAL	2,586.0	+6	129.0	-1	0.42	0.50	+0.08
5	0.52	0.52	—	MBNA	NA	NA	457.8	+20	0.34	0.35	+0.01
68	0.33	0.36	+0.03	McDONALD'S	3,862.1	+4	497.5	+13	0.37	0.39	+0.02
76	0.50	0.21	-0.29	McKESSON †	13,628.0	+17	117.3	+11	0.40	0.39	-0.01
0	0.36	0.29	-0.07	MERRILL LYNCH	7,352.0	-29	634.0	+17	0.71	0.66	-0.05
14	0.36	0.39	+0.03	MORGAN STANLEY	8,149.0	-35	797.0	-14	0.74	0.72	-0.02
0	0.56	0.54	-0.02	NATIONAL CITY	NA	NA	392.8	+12	0.61	0.63	+0.02
31	0.25	0.29	+0.04	NEW YORK TIMES	772.2	+2	78.8	+225	0.50	0.51	+0.01
14	0.44	0.44	—	OFFICE DEPOT	2,644.3	+4	56.9	+36	0.20	0.18	-0.02
71	2.13	2.43	+0.30	PROGRESSIVE	2,256.5	+21	160.4	+55	0.71	0.71	—
00	0.50	0.38	-0.12	SAFEWAY	8,081.3	+1	309.3	+1	0.77	0.63	-0.14
26	0.25	0.28	+0.03	SCHWAB (CHARLES)	1,049.0	-2	98.0	NM	0.09	0.07	-0.02
71	0.08	0.18	+0.10	SEARS, ROEBUCK	10,142.0	0	420.0	NM	1.10	1.31	+0.21
NM	0.17	-0.83	-1.00	SOUTHWEST AIRLINES	1,472.8	-5	102.3	-42	0.12	0.13	+0.01
25	0.44	0.47	+0.03	SUNTRUST BANKS	NA	NA	343.7	-6	1.20	1.20	—
18	0.56	0.56	—	SUPERVALU †	5,849.2	-16	77.2	+35	0.58	0.57	-0.01
13	0.82	0.86	+0.04	TENET HEALTHCARE †††	3,738.0	+16	321.0	+113	0.60	0.64	+0.04
71	0.72	0.63	-0.09	TRAVELERS PROPERTY CASUALTY	3,320.0	+11	332.0	-8	0.34	0.33	-0.01
NM	0.21	0.45	+0.24	UAL	3,793.0	-19	-340.0	NM	-6.68	-6.08	+0.60
12	0.58	0.54	-0.04	UNION PACIFIC	3,154.0	+5	304.0	+25	1.03	1.15	+0.12
2	1.11	1.42	+0.31	UNITEDHEALTH GROUP	6,078.0	+5	325.0	+46	0.94	1.01	+0.07
78	0.54	0.52	-0.02	USFREIGHTWAYS	626.7	0	5.9	-48	0.38	0.22	-0.16
20	0.61	0.61	—	WALGREEN ††	7,397.9	+17	259.0	+21	0.25	0.25	—
34	0.56	0.78	+0.22	WASHINGTON MUTUAL	NA	NA	985.0	+23	0.99	1.01	+0.02
47	0.72	0.86	+0.14	WELLS FARGO	NA	NA	1,420.0	NM	0.82	0.82	—
4	0.77	0.77	—	YELLOW	842.5	+2	6.2	+10	0.20	0.22	+0.02
28	0.75	0.77	+0.02	TECHNOLOGY	58,414.0	-4	334.6	-85	0.18	0.01	-0.17
60	1.45	1.53	+0.08	APPLE COMPUTER ††	1,429.0	-3	32.0	-48	0.13	0.09	-0.04
79	0.53	0.76	+0.23	EMC	1,387.5	-31	0.8	-99	-0.02	0.00	+0.02
49	0.51	0.63	+0.12	GATEWAY	1,004.9	-33	-58.5	NM	-0.17	-0.19	-0.02
11	0.52	0.49	-0.03	GENENTECH	622.3	+29	-213.6	NM	0.22	-0.41	-0.63
9	0.33	0.32	-0.01	IBM	19,651.0	-6	445.0	-79	0.87	0.25	-0.62
14	1.23	1.21	-0.02	INTEL	6,319.0	0	446.0	+128	0.15	0.07	-0.08
41	0.99	0.95	-0.04	MICROSOFT †††	7,253.0	+10	1,525.0	NM	0.42	0.28	-0.14
66	2.29	2.29	—	MOTOROLA	6,741.0	-10	-2,321.0	NM	-0.04	-1.02	-0.98
64	0.54	0.54	—	ORACLE ††	2,773.8	-16	655.9	-23	0.12	0.12	—
NM	0.31	0.34	+0.03	SANMINA-SCI ††	2,617.6	+237	-5.0	NM	0.03	-0.01	-0.04
45	0.40	0.31	-0.09	SOLETRON ††	3,032.8	-24	-287.0	NM	-0.05	-0.35	-0.30
131	1.25	1.18	-0.07	SUN MICROSYSTEMS †††	3,420.0	-14	20.0	NM	0.01	0.01	—
NM	0.57	-0.04	-0.61	TEXAS INSTRUMENTS	2,162.0	+6	95.0	NM	0.06	0.05	-0.01
6	1.20	1.23	+0.03	UTILITIES & TELECOM	66,274.2	-5	-16,983.0	NM	0.24	-0.99	-1.23
52	0.43	0.46	+0.03	AT&T	12,104.0	-9	-12,749.0	NM	0.04	-3.49	-3.53
28	0.63	0.79	+0.16	BELLSOUTH	5,780.0	-3	293.0	-67	0.58	0.16	-0.42
NM	0.30	0.56	+0.26	CONSOLIDATED EDISON	1,900.2	-10	101.0	-3	0.49	0.46	-0.03
15	1.45	0.91	-0.54	DOMINION RESOURCES	2,347.0	+2	271.0	+75	0.92	0.97	+0.05
33	0.62	0.58	-0.04	DUKE ENERGY	16,333.0	+5	474.0	+13	0.56	0.56	—
105	0.57	0.48	-0.09	FPL GROUP	2,249.0	+4	254.0	+14	1.31	1.46	+0.15
84	0.50	0.51	+0.01	LUCENT TECHNOLOGIES ††	2,949.0	-50	-7,864.0	NM	-0.10	-2.30	-2.20
NM	-1.93	-3.19	-1.26	NEXTEL COMMUNICATIONS	2,154.0	+25	123.0	NM	-0.28	0.37	+0.65
10	1.39	1.40	+0.01	SBC COMMUNICATIONS	10,843.0	-6	1,845.0	-11	0.60	0.55	-0.05
+19	0.68	0.71	+0.03	SOUTHERN	2,632.0	+3	337.0	+23	0.42	0.47	+0.05
27	0.21	0.22	+0.01	SPRINT FON GROUP	3,965.0	-8	102.0	-65	0.33	0.12	-0.21
+37	0.86	0.92	+0.06	SPRINT PCS GROUP	3,018.0	+32	-170.0	NM	-0.12	-0.17	-0.05
+21	0.37	0.25	-0.12								
+72	0.03	0.08	+0.05								
+12	0.81	0.78	-0.03								

† First-quarter results

†† 3rd-quarter results

††† 4th-quarter results

NM = not meaningful

NA = not available

Data: Standard & Poor's COMPUSTAT, Earnings Estimate Data Provided by Thomson Financial/First Call

THE ECONOMY

WILL WALL STREET SQUASH GROWTH?

If the market rout continues, consumers and execs could cut spending—and slow the recovery



To hear most economists tell it, growth is on a glide path to a vigorous expansion. Consumer spending is still strong, and the housing market remains buoyant. With corporate profits for most companies perking up, the last pieces needed for a full-bore recovery are about to fall into place: stepped-up hiring by business and increased capital spending.

It all sounds just fine. And a lot of the economic data even seems to bear it out. There's just one problem. Should the savage sell-off in the stock market continue, it could swamp all that good news and turn economists' rosy scenario into a far darker one. The sudden swoon in shares has left investors shell-

shocked. Despite July 24's huge rally, the market is still off 13.6% since President Bush spoke to Wall Street earlier in the month. Even if a rally develops, the market slide has finally driven home to Americans that they can no longer depend on the stock market to do their saving for them. That's got many reassessing their free-spending ways. "Now I'm not going to get a new BMW," says 28-year-old Scott McAuliffe of Atlanta. "Instead, I'm going to get a used Honda Accord." Multiply that caution across millions of Americans and it's easy to see why trouble may be brewing for the economy despite a recovery that ostensibly began at the start of the year.

But it's not just personal consump-

tion that will risk if stocks are sliding. The collapse of the market could lead to a vilification of the venerable CEO, threatening to paralyze corporate decision-making.

Those models, though, assume that interest rates fall in response to the lull in the stock market, cushioning the blow to the economy. Treasury bond yields and mortgage rates have dropped as stocks have tanked. But worries about the veracity of corporate balance sheets have kept corporate bond yields from enjoying a similar fall. And Fed Chairman Alan Greenspan has shown no sign yet of being willing to cut short-term interest rates, although Greenspan would undoubtedly act if the financial market suddenly seized up. There was a whiff of that happening early on July 24 as T

tion that will risk if stocks are sliding. The collapse of the market could lead to a vilification of the venerable CEO, threatening to paralyze corporate decision-making. They're delaying expansion plans, putting off hiring. That's imperiling the much-hoped-for recession-led bounce in the economy in months ahead. The market is telling the economy is to be very weak in the second half," says James W. Paulsen, chief investment officer for Wells Fargo Management.

How weak? Most macroeconomic models, including those employed by the Federal Reserve and the White House, reckon that the lapse in stock prices this year will subtract anywhere from a point to one full percentage point off economic growth in the coming

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sure bond yields plunged on a flight by investors to liquidity. But the danger passed as the stock market rallied.

What's more, the models don't pretend to predict whether the crisis on Wall Street will lead to a wholesale breakdown in confidence on Main Street. "The sharp break in the stock market creates uncertainty, and the uncertainty itself can have an effect on spending," says Chris Varvares, president of consultants Macroeconomic Advisers LLC.

So far, that doesn't seem to be happening. Yes, consumer confidence tumbled in July to its lowest level in eight months. But comments from retailers, auto dealers, and others on the front lines of the economy suggest that consumption is fraying, yet not cracking, under the strains of the stock slump. Retail sales actually rose 1.1% in June, although since then they've been mixed.

Thanks to the reintroduction of 0% financing, carmakers' sales soared in July, a fact cited approvingly by Greenspan. And the housing market, buoyed by a recent plunge in mortgage rates, remains strong. "We are not seeing any indications that the consumer is pulling out of the housing market," says Stuart A. Miller, chief executive of Lennar Corp., one of the nation's largest homebuilders. "To the contrary, people are looking more favorably on the housing market [as stocks sink]."

In industries closely linked to housing, though, the market sell-off has clouded otherwise sunny skies. In a disturbing disconnect, Stanley Furniture Co. in Stanleytown, Va., has seen furniture sales slide even as the housing industry has continued to boom. "If the evening news leads off with 'another bad day on Wall Street,' then that's tough," says CEO Albert L. Prillaman. "Consumers are taking advantage of low interest rates but living with some empty rooms for a while."

Some other areas of the economy that service consumers are also not faring well. Companies as diverse as airline UAL Corp., appliance maker Maytag,

and high-end consumer electronics retailer Tweeter Home Entertainment Group Inc. all reported a sudden sales slump in June, coinciding with the stock slide. Says UAL President Rono J. Dutta: "It looks like things stalled."

Call it payback for the go-go-years of the late '90s. As stock prices zoomed ahead at the end of the last decade, personal wealth soared, reaching a record high of 622% of aftertax income in the first quarter of 2000, the height of the bull market. Not surprisingly, given the pumped-up value of their portfolios, many Americans felt comfortable saving less and spending more. The savings rate, as measured by the Commerce Dept., fell all the way to 0.4% personal disposable income in September, 2000, from 6.1% in 1994, before the boom.

For a time after the stock market peaked, the relentless rise in housing prices helped cushion the blow from Wall Street as homeowners saw the value of their real estate increase. But the startling acceleration in the stock market slide in recent weeks means that's no longer the case. According to calculations by Merrill Lynch & Co. chief economist Bruce Steinberg, personal wealth as a percentage of income is now back to about 485%. That's a level not seen since the mid-1990s, before the boom. To make up for the evaporation of so much wealth, argues Goldman, Sachs & Co. Chief U.S. Economist William C. Dudley, Americans will need to raise the savings rate back up to the pre-boom levels of an average 8%, from 3% now.

Corporate America, of course, has already done a lot of housecleaning since

the late '90s. Companies have slashed inventories and cut back business investment. With corporate balance sheets in better shape, the hope was that companies were now poised to sharply increase spending and hiring.

Better think again. If the stock market slide continues, corporate chiefs will remain cautious, and could cut back twice about boosting capital investment. That's already hitting equipment

pliers—from IBM to Caterpillar Inc. In some cases, such as telephone equipment maker Lucent Technologies Inc., it's prompting a round of layoffs, putting the economy further at risk.

That means the dreaded double-dip recession can't be ruled out, especially if stock prices fall further. Indeed, chief global economist Allen Sinquefeld of Decisions Economics Inc. says the chances of a downturn during the next 18 months as high as 10%, even if stocks stabilize.

Unless stocks stage a major turnaround, an extended period of slow, disappointing growth looks likely. During the go-go years, Greenspan reckoned that the booming stock market boosted economic growth by one percentage point per year. Now the reverse is happening. So instead of the 3½% to 4% annual growth most economists expect over the next 18 months, the U.S. may have to settle for something closer to 2½%. It won't feel good or particularly pretty, but it's a whole lot better than a double dip.

By Rich Miller in Washington, Brian Grow in Atlanta, with Robert Berner and Michael Arndt in Chicago and bureau reports



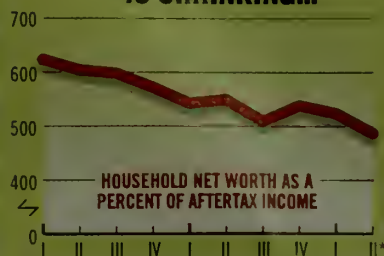
SECOND THOUGHTS

Companies as diverse as airlines and appliance makers reported a sudden slump in sales in June

MARKET FALLOUT

Data: Federal Reserve Board
Merrill Lynch & Co. University
of Michigan, Commerce Dept.

WEALTH IS SHRINKING...

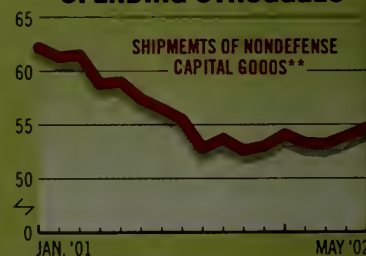


*ESTIMATE FOR APRIL 1 THROUGH JULY 22

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...AS CAPITAL SPENDING STRUGGLES



▲ BILLIONS OF DOLLARS

**EXCLUDING AIRCRAFT AND SEMICONDUCTORS



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INSURANCE, FINANCIAL SERVICES AND THE FREEDDM TO DARE.

TECHNOLOGY

UPTURN? WHAT UPTURN?

Tech execs expect their customers to keep a lid on spending until next year

By rights, the engines of a high-tech turnaround should be starting to roar, speeding toward a recovery in the last half of 2002. Domestic production of such high-tech gear as computers, chips, and electronic components has surged 12% since the start of the year. Excess information-technology inventories have been whittled down 4.5% since then too. And corporate profits are again rising in some sectors of the economy, meaning companies should have the cash to upgrade their systems.

But the high-tech bounceback—which tech execs and analysts widely expected in the second half of 2002—is behind schedule. More than half of chief information officers who took part in a June Morgan Stanley survey don't see the economy improving until 2003. Only four months before, only 16% of CIOs felt that way. Moreover, more than half of corporate IT buyers say they will conserve their tech budgets for the rest of '02, according to a survey released July 11 by Goldman, Sachs & Co. And on July 23, Merrill Lynch & Co. downgraded the stocks of 11 chip companies because it felt they had been too bullish about potential orders. "The change in sentiment has been dramatic," says Michael Shulman, director of research at Change-Wave Research. "It even calls into question the kind of growth you'll get in the first half of 2003."

TECH PROSPECTS

What the CEOs think



MAKING SERVERS: To trim costs, many companies are cutting the number of servers they run

With the economy on the mend, why the trouble in Techland? Because demand for high-tech products simply hasn't materialized as expected. The uncertain economy and continued market woes are prompting companies and consumers alike to put major buys on hold. "There is just not a lot of business being done in the IT market," says Thomas M. Siebel, CEO of Siebel Systems. "We don't see any reason why it should get better in Q3 and Q4."

Of course, tech execs have a history of incorrectly forecasting demand—particularly when the underlying trends shift. The same could be happening now. Despite predictions of brisk back-to-school and pre-Christmas sales that prompted many tech companies to gear up production during the past few quarters, the long-awaited turn isn't materializing. Merrill Lynch says orders for chips used in PCs, cell phones, and home-networking gear peaked in June. It cut the sector's growth target for the

fourth quarter, from 5.4%, as inventories at chipmakers, such as Corp. have grown. "Customers have clearly started to dither and will take less inventory risk given weak markets," says Merrill analyst Heyler.

Meanwhile, software server makers are waiting for customers to install and optimize the products they've chased during the late 1990s. That could take a while. Research Inc. estimates only half of the businessware bought since 1995 is in use. The Goldman Sachs survey found that repackaging hardware is a low priority for CIOs. Indeed, consolidation, costs and complexity, and companies ranging from Ecolab Chemical to General Motors to IBM are consolidating

number of servers and software applications they run. IBM, for example, is running 1,500 e-mail servers in 2002, thanks to improved efficiency, it expects to have 500 by the end of the year.

To be sure, the positive news is that the economy should not be ignoring the slowing wage growth allows corporate profits to continue picking up, that means more cash to invest in new equipment and systems. Even though 60% of the Morgan Stanley CIO respondents expect a near-term rise in profits won't translate into bigger IT budgets, some will be spending. And technology imports as a whole have inched up over the last three months, topping the year-ago pace. This all points to tech spending slowing but outpacing nominal gross domestic product in 2003, according to Goldman Sachs. But hopes for a recovery any earlier than that are fading fast.

By Ben Elgin, with Jim Kerschner and Cliff Edwards, in San Francisco, Calif., and Faith Keenan in Boston

OUTLOOK

WHY

NETWORKING GEAR

Won't stabilize until 2003

After a 22% plunge in 2001, at least corporate purchasing has stabilized. But less spending by telecoms will likely cut sales 8% below first-half 2002 levels through yearend.

PCs

Some growth possible in late 2002

PC shipments fell about 8% in the second quarter as consumers and corporate buyers cut back. But analysts expect help from back-to-school buyers, holiday shoppers, and last-minute corporate buys.

CHIPS

Potential for moderate improvement in late 2002

Double-digit hikes through May slowed to 5% in June as inventory rebuilding eased. But chipmakers expect more call for next-generation cell phones, home-networking gear, electronics, and PCs.

SOFTWARE

Little chance of recovery in 2002

New business software sales are down as much as 25% in the second quarter. Services revenue remains strong, but with fewer software deals in the pipeline, services sales will fall, too.

IQ



Intelligence Quotient / *abbrev: IQ*

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COMMENTARY

By Lee Walczak

DEMOCRATS POINT, BUT THEY MAY OVERREACH

It's a scorching Washington summer, but Republicans are doing most of the sweating. The stock market is melting like an ice-cream cone on a hot sidewalk. Corporate accounting problems continue to rattle investors. To top it off, there's the Bush factor. While George W. Bush conveys a steely resolve in the war on terrorism, he looks like a rattled rookie in the role of economic confidence-builder. The President says the fundamentals are sound. But polls show that confidence in Bush's economic stewardship is flagging.

That's a nightmare scenario for Republicans, and it explains why many now embrace the accounting reforms pushed through a House-Senate conference committee by Senator Paul S. Sarbanes (D-Md.). But it isn't Armageddon—yet. Polls show voters aren't ready for a partisan rebuke like the one aimed at Ronald Reagan in the recession year of 1982. That year, the GOP lost 26 House seats while gaining one Senate slot. Indeed, in an Ipsos-Reid poll taken July 11-21, Republicans held a surprising 48% to 40% lead among likely voters in the battle for Congress. Until those numbers turn around, don't expect Teapot Dome II.

Still, House Minority Leader Richard A. Gephardt is convinced a mighty wave is about to propel Democrats back to power in Congress. His strategy is simple: Produce TV ads that blast Republicans for voting to weaken financial safeguards, and let sinking 401(k) portfolios do the rest. "This is a big opportunity," exults David Axelrod, a Democratic consultant in Chicago. "It's true that there hasn't been a shift yet in the generic vote, but in '94 [when Democrats lost the House] the big break didn't come until the fall."

Of course, in 1994 Newt Gingrich managed to nationalize the election around the Contract With America—



DEMOCRATIC ADS: Dingell as corporate gadfly

a mash note to laissez-faire and deregulation. This year, Democrats are undertaking something harder: to channel unfocused anger at business greed into an anti-Republican tide.

Difficult? Yes. But it's not rocket science. Already, American Family Voices, a liberal advocacy group, has run TV ads in New York and Washington that depict Team Bush as soft on corporate crooks. For example, supporters of Michigan Democrat John D. Dingell—a veteran fighting for re-election in a redrawn House district—are airing an ad that trumpets his role as

a corporate gadfly. The spot boasts that "BusinessWeek calls Dingell 'large thorn in the side of Big Business.'" True, Dingell frequently sides with liberals. But he is also a fierce defender of the auto industry and ten tangles with consumer groups and environmentalists.

In Republican ranks, there is growing dread over the economic storm—but no road map to safety. By belatedly signing on to the corporate cleanup drive on Capitol Hill, "Republicans can fight that issue to a draw," says GOP strategist Charles Black. "The real danger is an economic slowdown that works against Republicans as the party in power."

It's not just Republicans who are worried. The backlash against business excesses is also taking its toll on CEOs' legislative agenda. On Capitol Hill, pro-business bills are drawing heavier fire. For instance, legislation to restore fast-track trade negotiating authority is being jeopardized by labor and environmentalist claims that it is a giveaway to corporations. And consumer groups battling a rewrite of bankruptcy laws claim they're also making headway. Why? Because the bill can be portrayed as helping big creditors. Foes hope to prevent passage this year—and to stall the measure indefinitely.

In reality, there's little Republicans or business lobbyists can do now but hang on for dear life.

And Democrats, for their part, could still overreach. Says pollster John Zogby: "They could blow it by overusing the 'little guy vs. giant corporations' rhetoric." That's because many investors are repelled by class-based appeals and reforms that seem anti-growth. Indeed, Ipsos-Reid found that the GOP has made small gains with independents lately—a sign that an immense opportunity for Democrats could yet be blown by a lapse into retro-politics.

Shifting Winds

How Americans view Bush's handling of the economy

	APPROVE	DISAPPROVE
JUNE*	63%	34%
JULY**	55	42

* Average result from Ipsos-Reid surveys conducted from April-June

** Results from surveys of 2,000 adults conducted July 11-15 and July 18-21

Data: Ipsos-Reid Public Affairs polls

Walczak
BusinessWeek
Washington
bureau chief

tim•ing / *noun* 1: the capacity
to choose for utmost effect
the exact moment for taking
action.



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EDITED BY DOUG ROYALTY

A BIG BOOST FOR CORPORATE REFORM

CHALK UP A MAJOR WIN FOR corporate reformers—and Democrats. The accounting bill adopted by House and Senate negotiators on July 24 differed only slightly from Senate Democrats' tougher version. Business and accounting lobbyists had counted on killing the bill, championed by Senate Banking Committee Chairman Paul Sarbanes (D-Md.), but their clout melted away after WorldCom's bankruptcy. The bill, which President Bush is expected to sign in August, establishes an independent board to write auditing rules and discipline wayward accountants. It also bars accounting firms from consulting for their audit clients and cracks down on Wall Street's conflicted analysts. House Republicans did raise the bar on criminal prosecution of executives: Prosecutors can only charge violations that are committed

knowingly, not recklessly. But execs who are caught will face stiffer penalties, with sentences as long as 25 years. One thing the bill won't do: boost the SEC to Cabinet rank, as requested by Chairman Harvey Pitt.

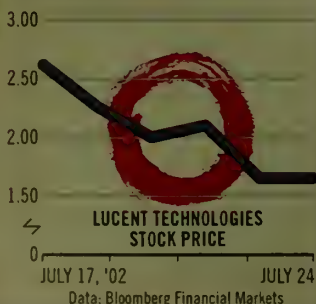
THROWING THE BOOK AT ADELPHIA

ALLEGING "ONE OF THE MOST extensive financial frauds ever to take place at a public company," the SEC on July 24 charged Adelphia Communications founder John Rigas, two sons, and two other executives of the Coudersport (Pa.) cable company with hiding off-balance-sheet loans, enhancing operating earnings by falsifying information, and "rampant self-dealing" that included buying stock, condos, and timberland with company funds. The defendants, if convicted, face up to 30 years in prison and millions of dollars in fines. Another Rigas son was named in the SEC complaint but was not arrested.

CLOSING BELL

SEEING RED, AGAIN

Investors shed Lucent Technologies shares after it posted a \$7.91 billion loss on July 23, its ninth straight red-ink quarter. The telecom-equipment maker's shares tumbled 21%, to \$1.65, as it lowered earnings guidance for the year and announced 7,000 job cuts. Said CEO Patricia Russo: "Capital-spending constraints have intensified."



POWER MARKETERS GET ZAPPED

THE BAD NEWS KEEPS COMING in the power-merchant and energy-trading sector. On July 23, shares of virtually every player tanked on troubling reports from Williams, Dynegy, and El Paso. On July 22, Williams said its struggling energy marketing and trading business would cause it to report a second-quarter loss. Shares sank 77% in two days. On July 23, Dynegy stock plunged 64% after the company slashed its cash-flow outlook for 2002. That day, El Paso shares fell 23% on concerns about a venture in its electricity-restructuring business called Project Electron. It's at the center of a series of complex off-balance-sheet partnerships that helped

HEADLINER: E. STANLEY O'NEAL

A MILESTONE AT MERRILL

Everyone expected Merrill Lynch President E. Stanley O'Neal, 50, to become chief executive of America's No. 1 brokerage. They just didn't realize it would be so soon. On July 22, Merrill announced that O'Neal will succeed David Komansky as CEO in December. Next April, Komansky, 63, will retire as chairman, and O'Neal will assume that post, too. He will be the first African American to run a top investment bank.

Since becoming president in July, 2001, O'Neal has led Merrill through a

painful restructuring, shedding thousands of jobs amid a market meltdown.

His next challenge will be to achieve Merrill's goal of posting a 24% pretax margin next year. O'Neal is on his way. In the second quarter, pretax margins rose four percentage points year on year, to 19.1%, despite an 11% decline in net revenue. Excluding a \$100 million settlement with New York State Attorney General Eliot Spitzer and related costs, Merrill's pretax margin was 21.4%.

By Emily Thornberry
New York Times



El Paso book millions in profits years before they'll be realized, while keeping billions in debt off its books. The company says it followed accounting rules.

AOL: YOU'VE GOT REGULATORS

AOL TIME WARNER'S EFFORTS to hold off the advertising bust have roused the SEC. On July 24, CEO Richard Parsons acknowledged that the agency was conducting a "fact-finding inquiry" into America Online's accounting. It comes after *The Washington Post* reported how the AOL unit used aggressive measures—including bartering ads for computer equipment and settling lawsuits with ad deals—to bolster ad revenues and meet Wall Street's targets for three quarters in 2000 and 2001. AOL has denied any problem with ad accounting.

ANOTHER DUSTING FOR MARTHA

MARTHA STEWART'S INSIDE trading battle is biting her company's fortunes. On July 24, Martha Stewart Living Omnimedia said it expects profits of 6¢ to 7¢ a share in the third quarter, less than half analysts' projections. Stewart is fighting allegations that she had inside information in dumping shares of drugmaker ImClone Systems—and now investors are suing the banks that handled her IPO, calling it rigged.

ET CETERA...

- Hewlett-Packard said it no longer sell printers through rival Dell.
- Amgen's second-quarter profits rose 28%, and the O.K.'d its anemia drug.
- The New York Stock Exchange may build a trading floor away from Wall Street.



PLAY AND PLAY... SINGAPORE

Infrastructure

Manpower

Connectivity

Innovation

Destination: Asia
Route Selected: Singapore

Game Goal:
Penetrate Region
of 3.6 Billion People

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EDITED BY LEE WALCZAK

JUST WHAT THE DOCTOR ORDERED OR THE FDA?

From the first days of the Bush Administration, the White House had one overarching goal for the Food & Drug Administration. No, it wasn't picking an agency head who would ban the abortion drug RU-486, a red-flag issue to Religious Right. Instead, the Bushies wanted a low-key, pliant commissioner who would be the antithesis of Dr. David A. Kessler, the crusading FDA chief who railed against tobacco and bedeviled Bush Sr. "The White House is absolutely committed to not having another Kessler," says a source close to the recruiting process.

Still, finding a candidate who fits this prescription has proved difficult, which explains why an agency that is routinely lashed by industry and conservative critics for slow drug approvals remains leaderless after 18 months. The void at the top may soon be filled. The White House is expected to nominate Dr. Mark McClellan, 39, a highly regarded health-care economist at Stanford University and a current member of the President's Council of Economic Advisers. Low-key, smart, and largely apolitical, he could be on the job by the end of the year. His academic studies examine the cost-effectiveness of new health-care innovations—the agenda he'll carry out at the FDA is expected to be favorable to industry. Already, the agency is considering easing restrictions on everything from drug ads to food labels, bringing up controversy and internal tensions.

McClellan isn't Bush's first choice. Last summer, the White House settled on Michael J. Astrue, a top Health & Human Services Dept. (HHS) official in the Bush Sr. Administration and vice-president at Transkaryotic Therapies Inc.—only to see him nixed by Senator Edward M. Kennedy (D-Mass.), who insisted that the new chief not have industry ties. McClellan's name is also raising eyebrows on Wall Street, where analysts fret that a cost-effectiveness expert may not be a

good fit in an agency charged only with ensuring that drugs are safe and effective.

But otherwise, McClellan fits the bill. He's an M.D. who passes Kennedy's litmus test. More important, he's a Bush team player, with strong ties to the President. Brother Scott is a White House press spokesman, and his mother, Carole Keeton Rylander, is Texas' comptroller and former mayor of Austin. "Unless someone digs up dirt on him, it's a pretty clean confirmation," says one observer.



CANDIDATE: Mark McClellan

If he gets the Hill O.K., McClellan would head an FDA that's already being reshaped. HHS Secretary Tommy G. Thompson "has his hands all over the agency"—vetting most regulations—says one industry source. More important, chief counsel Daniel E. Troy, who was appointed nearly a year ago, is already pushing the FDA down a deregulatory path. His philosophy: Agencies should limit their actions to what the law explicitly authorizes them to do.

For the FDA, which often creatively adapted its creaky old laws to fit new circumstances—especially under Kessler—that means limiting its reach. "The fact that Kessler stretched the law is the reason why Daniel Troy is there now," says one longtime FDA watcher.

Agency staffers are already complaining of micromanagement, delays, and being unable to carry out their mission of protecting the public.

Some are thinking about leaving. "There is a fundamental philosophical clash," says one agency official.

McClellan's task, if he gets the job, will be to lead the FDA smoothly down this less activist path. Some loosening of regulations is probably healthy, many agency watchers say. But if the FDA finds itself in hot water over unsafe products or egregious advertising claims, McClellan may find himself in a brighter spotlight than the White House expected.

By John Carey, with Howard Gleckman

CAPITAL WRAPUP

TUBBORNNESS PAYS

House Ways & Means Committee Chairman Bill Thomas (R-Calif.) held a conference committee on the fast-track trade bill for a week by insisting it was his turn to chair the panel. Senate Democrats insisted it was their turn to chair a conference, and Majority Leader Tom Daschle (D-S.D.) complained that Thomas was "jumping up and down and throwing things again." But on July 23, the conference finally got under way after both sides agreed that Thomas could fill the rotation.

WELL-ETCHED CHALLENGERS

► California's 12th congressional district voters can't say they lack choices. If they don't want to vote for incumbent Democrat Tom Lantos, a Holocaust survivor, they can choose Maad Abu-Ghazalah, a Palestinian-American software engineer running as a Libertarian. Lantos, a liberal and supporter of Israel, backs the Administration's anti-terror campaign. Abu-Ghazalah is a fiscal conservative, critic of Israel, and opponent of U.S. military action in Afghanistan. Lantos is favored.

DONDE ESTAN LOS DISTRITOS?

► Latino activists had been expecting at least six new Hispanic-majority House districts to be created by redistricting this year and as many as 10 Latinos to win election to the House in November. But early calculations by UCLA's Leo F. Estrada show that only three Latino districts will be fashioned from the new electoral map. Hispanics are particularly incensed that in Texas, where they accounted for 60% of the state's 1990s growth, no Latino district was created.



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IT'S MARCH 3RD
IN SALES.
TOO BAD IT'S
JANUARY 3RD
IN FINANCE.

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RUSSIA

RUSSIA'S NEW WEALTH

Moscow's young tycoons eye farming, banking, and more

With his smooth cheeks and angelic looks, Andrei Melnichenko seems awfully young to be one of the key players in the next stage of Russia's capitalist revolution. Yet Melnichenko has already helped turn Moscow's MDM Group into a \$3 billion-a-year chemicals, pipeline, and coal business. But in a country in which the free-market economy is barely more than 10 years old, the players may look like cherubs but can bite like wolves. "He's 30—and he wants to own the world," says Len Blavatnik, a Russian-born U.S. citizen who invests in oil and aluminum and who, at 45, is an elder in Russia's big business set.

Bona fide senior tycoons sure take Melnichenko's moves seriously. His big play? It's not oil or metals, the traditional industries where a tycoon earns his stripes in this tumultuous economy. No, he's headed back to the land, the land that once made Mother Russia great. Russia's farming sector is poised to boom with the recent passage of leg-

islation that authorizes the private ownership of agricultural acreage. That has set off a scramble for the choicest plots. If a few companies can introduce modern farming on these vast tracts, the increase in grain yields could be enormous.

That's why Melnichenko has quietly invested \$220 million in Russia's best fertilizer plants. He figures the new landowners will need massive supplies to revive poorly cultivated plots. According to Melnichenko, profit margins in MDM's fertilizer foray are 20% and rising. "It is relatively easy money," he says between puffs of his habitual Philip Morris cigarette.

Melnichenko—and Blavatnik and a host of other tycoons old and new—are deep into the hunt for the Next Big Thing in Russia's economy, a hunt that's reaching into previously neglected areas such as agriculture, natural gas, electricity, railroads, and financial services.

These investments are in the stages. But a coterie of billionaire businessmen are building on their po savvy and dealmaking skills to el the right plays. And if they succe grabbing big stakes, they may we cide to pump a big portion of thei tunes into Russia rather than Swis las or bank accounts in Cyprus.

This is the third big-money gar Russia since the demise of the S Union. In the first stage, beginnin fore the Soviet Union's crack-up in communist industrialists carved b moths such as gas giants Gazprom Lukoil directly out of Soviet minis Assets were stripped and massive



A \$90 Billion Fortune Hunt

Some 30% of the economy's GDP of \$300 billion is up for grabs. The major prizes:

Data: BusinessWeek, Prosperity Capital Management, Russian State Statistics Committee, World Bank

GAS

8% of GDP

Potential: Debt-ridden monopoly Gazprom could go bankrupt, giving the circling oil-baron sharks a major kill. Even if it doesn't, independent gas producers will gain access to its pipelines. Russia has a 32% share of the world's proven gas reserves but only 22% of total production.

RAILROADS

8% of GDP

Potential: The corrupt Railways Ministry is embarking on a privatization. Big industrial barons are getting in on the ground floor by snapping up depots, repair facilities, and other assets. With Russia plagued by bad roads and frozen rivers, the rails are always going to be big business.

AGRICULTURE

8% of GDP

Potential: Large-scale farmers buying farmland, fertilizer factories, processing plants. Export plans don't put domestic producers to take back a big slice. \$50 billion in food imported by Russia.



Vladimir Potanin

41

Position: President, Interros, Moscow.

Background:

Devised the loans-for-shares auctions in the 1990s to capture Soviet metals giant Norilsk Nickel.

New Plays: Food products and entertainment/media.

Now comes the third stage. The carve-up—and the cleanup—of the Oil Patch is largely done. This time the assets are in big unreformed chunks of the economy. Not only is President Vladimir V. Putin's government

paving the way for a private market for farmland, it's also poised to break up monopolies in natural gas, utilities, railroads, and banks, and even start the private management of pension funds. Altogether, the sectors up for grabs account for some 30% of Russia's gross domestic product of \$300 billion. That's \$90 billion in prizes.

Four years after a financial crisis that nearly devastated the country, and with political stability seemingly assured under Putin's authoritarian rule, Russians are starting to feel secure. Although the Russian stock market is now taking some sharp hits, the big Moscow index is up 27% for the year. Inflation is relatively low at 17%,

down from triple-digit levels a decade ago. "Money is coming back," says senior economist Peter Westin of Aton Capital Group, a Moscow brokerage. Last year, Cyprus, a haven for Russian funds, was the leading source of foreign investment, at \$2 billion, 15% of the total.

Even if Putin con-

tains the corruption in this next stage of privatization, he will also have to curb the monopolistic instincts of his tycoons. The tycoons counter that the economy is still too uncertain for them to act otherwise. "If we don't have a strong position, we will lose," says 34-year-old Oleg Deripaska, who with his partner controls 70% of aluminum production.

The game is well under way. A prime jackpot will be the country's natural-gas wells and pipelines. At the center of it all is Gazprom, which operates the monopoly gas-pipeline network and is responsible for 90% of gas production. The government, which owns 38% of Gazprom, should soon open its pipeline to other producers. So this year, Yukos paid \$121 million for 100% control of bankrupt Rospan, whose reserves have a market value of \$9 billion. A sharp fight followed with rival Tyumen Oil, which cried foul over Yukos' acquisition methods. Yukos

Mikhail Khodorkovsky

39

Position: CEO, Yukos, Moscow.

Background: Won

Yukos, a state oil property, in rigged loans-for-shares auctions in mid-1990s and made paper fortune of \$7 billion with appreciation in Yukos shares.

New Plays: Gas and electricity.



ted out of the country. In stage in the mid-1990s, government-con-

ed bidders won prize oil and metals companies in rigged privatizations. The

st players made a killing. When something amazing happened:

more astute winners actually in- ed in their oil and metal holdings, ing productivity and, in a few cas- uproving the rights of shareholders. oligarchs have hardly become an-

But the partial move to legitimacy made some of them even more pow- Mikhail Khodorkovsky, the con-

ersial CEO of Yukos Oil Co., for ex- le, is now worth \$7 billion—because tern investors believe his numbers.

cial services

ELECTRICITY

2.5% of GDP

Potential: Industrial players are trying to get in early to influence the restructuring of the Unified Energy System electricity monopoly by its chief, Anatoly B. Chubais, who wants to create a free market for electricity in Russia.

ment is plan- exclusive right Sberbank to guaranteed Upcoming would permit providers to retirement a new law makes compulsory.

International Business

later sold 44% of Rospan to Tyumen.

Gas fields are not the only fields drawing attention. At 406 million hectares, Russia has 13 times the farmland of France. Land is plentiful—and cheap enough to attract players such as Moscow metals mogul Oleg Kiselev. His Metalloinvest conglomerate is buying 320,000 hectares of farmland in central Russia, at just \$30 per hectare. Kiselev predicts that “in a few years” the price will reach \$1,000 per hectare. Others are more skeptical. But there’s huge room for growth just by catering

vestment firm Prosperity Capital Management. Generation plants and the distribution grid are now largely in the hands of Unified Energy System (UES), which is 53% state-owned. Key aspects of the UES restructuring plan are stalled in the Duma over concerns that consumers may be socked with huge tariff hikes. But the big players are plunging in now before the plan takes hold.

UES is a model of management compared with the railroad monopoly, run by the notoriously corrupt Railway Ministry. Undeterred, Blavatnik,

ing a dozen or more regional banks, including some specializing in providing government pension checks. The plan is to create an expertise—and relationship with the government’s Pension Fund—that can make Mironov the top dog in 2004. That’s when pension managers can finally bid to manage state retirement funds.

Then there’s insurance. Total premiums from life insurance and other products account for 1.5% of Russia’s GDP, compared with 10% in some developed countries. There’s “huge potential



Oleg Kiselev
45

Position: Leading shareholder in Metalloinvest, Moscow.

Background: Acquired stakes in metals and raw material companies.

New Plays: Purchasing farmland and railway assets.

Ruben Vardanian

34

Position: President, Troika Dialog, Moscow.

Background: He began running Troika Dialog brokerage in his early 20s.

New plays: Life insurance, auto insurance, and financial products.



Andrei Melnichenko
30

Position: President, MDM Group, Moscow.

Background: Built up commanding stakes in Russia’s coal and pipes industries.

New Plays: Fertilizer and pension funds.

Mikhail Fridman

38

Position: Chairman, Alfa Group, Moscow

Background: Made fortune with acquisition of big stakes in privatized Tyumen Oil

New Plays: Gas, high-tech banking services targeting Russia’s new middle class



to the domestic market. Imports now account for \$50 billion of Russia’s \$70 billion food-products market. “Can you imagine if [Russians] gain half of this market?” asks Kiselev. “It’s a big deal.”

Joining the land rush are other big players such as Moscow’s Vladimir O. Potanin. Author of the notorious loans-for-shares program in the mid-1990s, in which he gained control of the world’s largest nickel producer, Norilsk Nickel, for next to nothing, Potanin, 41, aims to make his next fortune in processed food products, land, and media. His Interros company is investing \$100 million in its new agricultural unit, Agros.

Russia’s electricity assets also look cheap. Generating capacity in Russia can now be bought for \$50,000 per kilowatt, compared with \$400,000 in Germany or Poland, estimates Moscow in-

Moscow industrialist Viktor Vekselberg, and Kiselev are putting money into railway assets now. The bet is that railroads will boom as Russia extracts and ships more of its commodities.

Just as in railroads, the tycoons’ foray into banks depends on the deconstruction of a state monopoly. That’s what Alfa Group Chairman Mikhail Fridman is hoping for. As things stand, his Alfa Bank has a tiny 2.3% of Russia’s ruble deposits—against 72% held by Central Bank-owned Sberbank, with its exclusive right to offer government-guaranteed deposit insurance. But the Central Bank is crafting a plan to allow deposit insurance at all properly supervised banks. Fridman is investing \$50 million in a new branch network modeled on Deutsche Bank’s Bank 24 in Germany. Melnichenko’s MDM is acquir-

Ruben K. Vardanian, 34, president of Moscow brokerage Troika Dialog, has paid \$40 million for a 49% stake in Gosstrakh, the Soviet-era monopoly provider of insurance. Greater stability, Vardanian notes, has lots more Russians buying life insurance, while a law makes auto insurance compulsory.

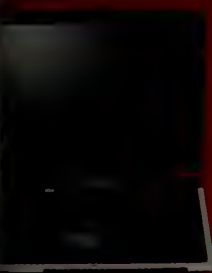
Of course, the tycoons could come empty-handed if Russia’s economy takes another 1998-type nosedive. And their chances are that much greater because of the perception of Russia as unpredictable. Without such wary assets wouldn’t be priced so cheap. “Controlled chaos” is the best environment for making big money, Khodorkovsky. And Russia’s young industrialists are hungry for fresh trophies.

By Paul Starobin, with Catharine Belton, in Moscow

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MARKETS

'CASH IS KING THESE DAYS'

But excess liquidity may damage the global economy

Equity markets are plunging. Corporate bonds are sagging. And as panicky investors rush for the exits, they are unleashing a wave of cash. Almost \$800 billion has been generated worldwide by dumping stocks over the past quarter, calculate market experts. Some of that is being reinvested in government bonds, real estate, or hedge funds. But the largest single chunk—some \$275 billion—has gone into cash deposits around the world. "Cash is king right now," says David Jeal, marketing manager at the Share Center, a British retail stockbroker.

Yet such prudence could vastly complicate life for policymakers: Those billions are not being channeled back into productive investments. "We foresee trouble ahead," says Stephen King, head of economics at HSBC Investment Bank in London.

Investors just about everywhere are bailing out of equities. And it's not just individuals who have fled their local markets. Many insurance companies, pension funds, and other institutions are bringing at least part of their money back home. Europeans pulled about \$58

billion from U.S. markets in the second quarter. Americans are bailing out overseas, too. "In times like this, investors feel more secure in markets they know best," says Lukas Daalder, head of research at Oyens & Van Eeghen, a brokerage in Amsterdam.

As the uncertainty mounts, some institutions have concluded that they can't expect to make the 15%-plus returns from stocks that they made during the bull market. Take British insurance companies, which have typically channeled up to 70% of their investments into shares. Most are selling off at least some of them and moving the money into other assets. "A major rebalancing is taking place," says Richard Reid, chief equity market economist at Schroder Salomon Smith Barney in London.

If the money being freed by the great stock sell-off went into other classes of equities or corporate bonds, it wouldn't be a big deal. But that's not the case.

"There is a lot of money out there isn't being invested," laments Bébér, founder and chairman of insurance giant Axa. Wary European investors, for example, are not even ed by corporate bonds. "Fear and are at extremes," says William C. ham, director of credit strategy Morgan Chase & Co. in New York. "Nearly all traditional valuations corporate bonds to be attractive spreads continue to widen."

The trouble with these huge ca ances is that investors could eve either do something dumb with the do nothing at all. First, the dumb There has been a noticeable up the volume of cash flowing into p ty—some \$200 billion globally. Th fueled the recent boom in house especially in Britain and the U.S. property boom, particularly in F is beginning to look like a bubble could soon burst, giving many inv as big a shock as the equity co Meanwhile, some \$29 billion wor flowed into hedge funds in the last ter. Since even hedge funds strugg make decent returns in this market are driven further into risky new i ments. Higher risk is not what the kets need right now.

The biggest worry is that all thi isn't being used productively. Abou the pile globally is going into r market or highly liquid funds. If ac managed, these funds can earn up from certificates of deposit and term treasuries. The other half is st bank deposits, with returns often 2%. Judging by central bank statisti tle of this cash is finding its way bank lending. In Germany comm lending has hardly increased ove past six months, causing some to credit crunch is on the way. Cash m king for investors, but hundreds o lions of dormant dollars and euro the last thing the global economy r

By David Fairlamb in France

THE GLOBAL STOCK SELL-OFF: WHERE THE MONEY IS GOING

	GLOBAL	U.S.	EURO ZONE	JAPAN	BRITAIN
SECOND QUARTER 2002	BILLIONS				
MONEY GENERATED BY SELLING SHARES	\$785	\$400	\$195	\$90	\$100
AMOUNT INTO CASH	275	150	75	35	40
AMOUNT INTO REAL ESTATE	210	100	40	25	30
AMOUNT INTO GOVERNMENT BONDS	170	80	50	20	25
AMOUNT USED TO REPAY DEBT	101	60	22	4	10
AMOUNT INTO HEDGE FUNDS	29	10	8	6	10

Data: BusinessWeek estimates, based on data from Westdeutsche Landesbank, Schroder Salomon Smith Barney, HSBC Bank

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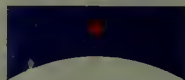
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CHINA: WILL JIANG'S POWER PLAY SET OFF POLITICAL UNREST?

was supposed to be the most orderly transfer of power in China's modern history. In a scenario planned years ago by then-paramount leader Deng Xiaoping, President Jiang Zemin was to step down as General Secretary of the Chinese Communist Party at the 16th Party Congress this fall. Hu Jintao, vice-president, head of the Communist Party School and one of Deng's anointed, would then take Jiang's place as chief and, next spring, as President.

But now, rumors are swirling that Jiang wants to hang on longer—and he's wooing party leaders for their backing.

In this turn of events, the party's annual summit now being held under way at the seaside resort of Beidaihe assumes tremendous significance. "This meeting will be crucial in shaping the final lineup of China's leadership," says Kenneth Lieberthal, a China expert who advised the Clinton Administration.

Jiang, 76, longs to ensure for himself a top place in Communist Party history books, alongside Mao Zedong and Deng. Observers say he wants to stay at the top to oversee his efforts of strengthening China's relations with the rest of the world, bringing Taiwan back closer to the mainland, and integrating China into the global economy. He wants to make his philosophy for expanding the party's—a theory known as the "Three Represents"—part of these doctrine. "He is looking to hold onto a maximum amount of power," says a Western diplomat in Beijing.

The risk is that by preserving a powerful role, Jiang could divide the party between mostly older cadres who support him and those officials—both younger and older—who want him to step down so a new generation can take the reins. Though these factions wouldn't largely disagree over policy, fighting could destabilize the country as it's facing key

challenges. At worst, analysts say, China could end up with a divided government at a time when impoverished farmers, unemployed workers, and others who feel victimized by reforms are taking to the streets. "You could end up with a prolonged period of social and political unrest," Lieberthal says.

No matter what unfolds at Beidaihe, Jiang will have to give up the presidency next year. China's constitution limits the President and Premier to two terms. But sources say Jiang is looking into staying on in the post of General Secretary or kicking himself upstairs to become party Chairman—a post eliminated after Mao's rule. Jiang may try some horse-trading

at Beidaihe. One idea making the rounds is that he will back the candidacy of Luo Gan for the powerful seven-member Politburo Standing Committee. Luo is the protégé of Li Peng, 74, the hard-line chief of the National People's Congress who is supposed to step down. With Luo in his new post, Li would still have influence: As payment, Li would likely back Jiang's bid to stay on. Analysts say Jiang aims to stack the Standing Committee with supporters. He is expected to keep his post as chief of the military.



RIVALS: Hu Jintao and Jiang Zemin

With all the maneuvering going on, the Party Congress, originally expected in September, could be postponed until November. Meanwhile, observers are watching the ever-cautious Hu, who is likely to count on the support of other leaders in his quest to become General Secretary as well as President. One ally may be Li Ruihuan, 68, a Standing Committee member and longtime Jiang adversary. The coming days could show whether Jiang follows the late Deng's wishes and relinquishes power gracefully—or tilts China into a period of political uncertainty.

By Dexter Roberts in Beijing

GLOBAL WRAPUP

WILL BERLUSCONI SELL?

Pressure is mounting on Italian Prime Minister Silvio Berlusconi to sell some of his media holdings and part of state-owned broadcaster RAI. On Aug. 23, Italian President Carlo Azeglio Ciampi called for new laws to curb the country's excessive media concentration and guarantee "pluralism and impartiality." That was seen as a sign of Ciampi's concern about Berlusconi's near-monopoly in Italian private TV through his family's control of 2.5 billion broadcaster Mediaset.

Thanks to his parliamentary majority, Berlusconi also effectively controls state-owned TV. While a bill on Berlusconi's conflict of interest is moving through Parliament, it doesn't require asset sales. Ciampi has the authority to send the bill back for revisions.

A SHAKY PEACE

► Rising street violence between Protestants and Catholics in Northern Ireland puts Britain's Tony Blair in a nasty bind. The province's First Minister, David Trimble, is pressing him to bounce Sinn Féin, the Irish Republican

Army's political wing, from the local government to punish republican sympathizers for fighting. But Blair is likely to reckon that such a harsh measure could jeopardize the overall peace. That increases the possibility Trimble will resign, as he has twice before, paralyzing local government.

Meanwhile, Trimble warns that Ian Paisley's Democratic Unionists, who oppose the Good Friday peace pact, and Sinn Féin could become the dominant parties in the province's assembly after next May's elections. That would bog down the government even more.

COMMENTARY

By Timothy J. Mullaney

AMAZON IS ALL GROWN UP, EXCEPT FOR ITS ACCOUNTING

It has been a fun debate, but it's just about over: The numbers make it increasingly clear that Amazon.com Inc. is out of the woods. On July 23, Amazon said second-quarter sales surged 21% to \$806 million. Operating cash flow was \$4.6 million, and its net loss came in at \$94 million, 44% less than the same quarter in 2001. Amazon probably won't make money this year under generally accepted accounting principles (GAAP)—a second-quarter currency adjustment of \$71 million took care of that—but true profits will almost certainly arrive in 2003.

So why don't more people believe in Amazon? Frankly, it's the company's own fault. Years of arguments over Amazon's accounting have left the online retailer with a dodgy reputation, in a market where credibility is everything. Since 1999, there have been at least three federal inquiries into Amazon's practices, and, though it hasn't had to pay any fines or make restatements, that has hurt Amazon's image. There is a solution. It's time for Amazon to banish two of CEO Jeff Bezos' favorite words: pro forma.

Why is it so important for Amazon to dump pro forma earnings? Now, with Net companies fighting for credibility and investors skittish about all stocks, Amazon needs to play the role of industry statesman. Because of mistrusted pro forma accounting, most people think truly profitable Web companies are rare. In reality, more than 50 of the roughly 200 public Internet companies make GAAP profits now, and others will follow soon. Back in Amazon's early days, before Enron and Worldcom, pro forma may have been a reasonable standard to judge nascent companies whose investments needed time to pay off. But now

Amazon, like other dot-coms, must understand that trust is worth more. Amazon took a big step in that direction on July 23 when it became the first Net company to say it would expense new stock options. By embracing GAAP, Bezos can finish the job.

Bezos has argued against projecting Amazon's GAAP results because those are affected by currency and

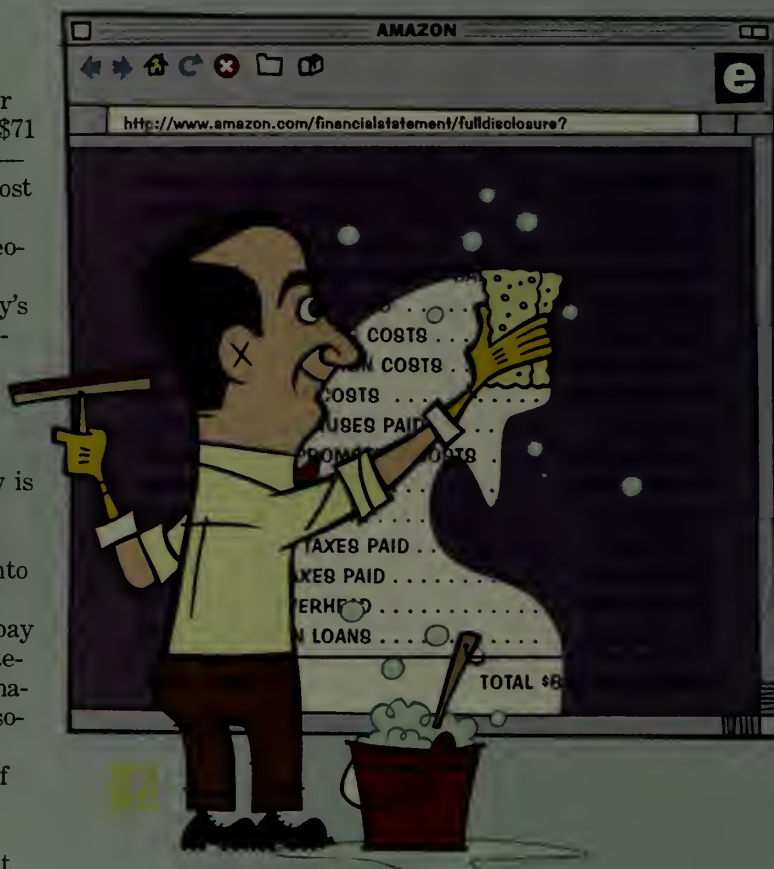
ees exercised their options when Amazon's stock rose. But Amazon can—and does—explain those issues on its GAAP cash-flow statement. It doesn't need the pro forma crutch.

Amazon can afford to give pro forma a rest. Besides the currency and stock adjustments, the difference between pro forma and real net income is getting tiny. Amazon's amortization expense is down to \$13 million a quarter from \$51 million a year ago. Even stock compensation expenses of \$34 million—mostly stock options—aren't much considering Amazon's \$1.1 billion in sales. And the adjustments will get small—still as options expire and depreciation falls more.

A clean break would let Amazon focus even more attention on its surprisingly clear path to profits from here. Costs are falling faster than promised, and sales growth—21% so far this year—has picked up from 2001. Mark Rowen of Prudential Securities Inc., who rates Amazon a hold, says it will make \$51 million net in 2003, even if sales growth slips to 10%. From there things should accelerate as Amazon pumps more business through the same warehouses. With real numbers like that, why fool with pro forma?

Jeff, if your foot hurts, stop shooting it. Next quarter, say: "I'll make X

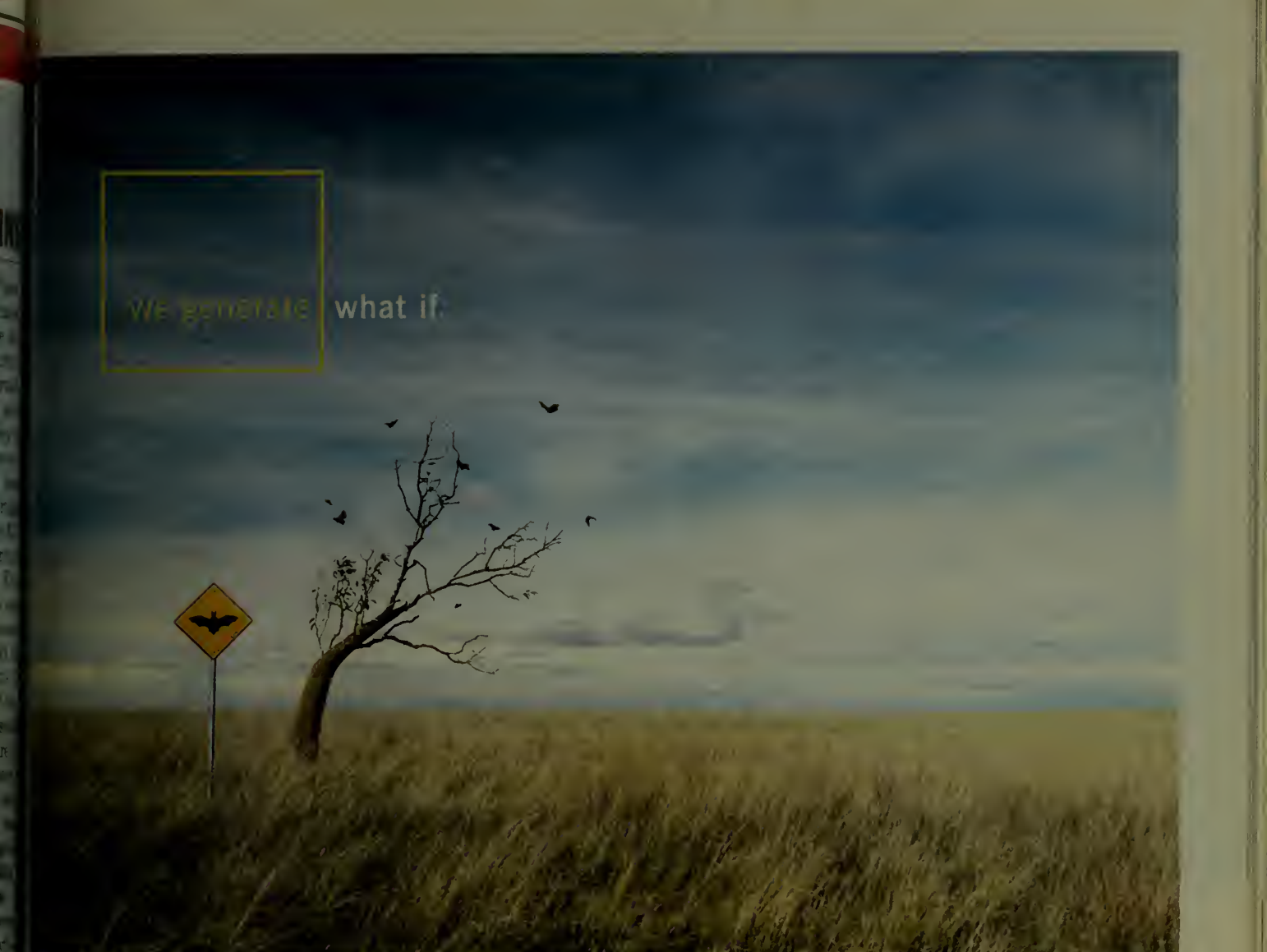
for the year under GAAP"—pick a number, or a range to allow for bounces in your stock and the euro. Skip pro forma. A recent Harvard University study shows the stocks of companies that followed best corporate practices beat the pants off cowboys in the 1990s. It'll be more true in this decade, and a white hat means GAAP accounting now.



Jeff Bezos will get more credit if he drops pro forma from his routine

stock market moves he can't control. "For me to predict GAAP earnings would require me to predict our stock price, which I'm not about to try to do," he says. Indeed, the rising euro and an increase in Amazon's stock price hurt the company's financial results in the second quarter. Amazon recalculates the dollar value of its euro-denominated debt each quarter, and those obligations rose by \$71 million this time. The cost of stock options was \$23 million because employ-

Mullaney covers technology and finance

A photograph of a field with a tree and a bat sign. The sky is blue with some clouds. The text "WE GENERATE what if" is overlaid on the top left of the image.

WE GENERATE what if

Spring 2000 – a 14-mile pipeline and six months stood between the Midwest and a repeat of the previous summer's blackouts.

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THE INTERNET

CAN MSN PLAY DAVID TO AOL'S GOLIATH?

It's still a distant No. 2 in market share, but opportunity knocks

Taped onto a stop sign on Microsoft's Redmond (Wash.) campus is a piece of paper bearing three letters: AOL. The message: Stop America Online Inc. After trailing AOL for years, Microsoft is mobilizing to steal market share from the top dog in cyberspace. It's rolling out a new version of MSN, gearing up for the switch to broadband Internet access, and signing up new customers at a rate of over 6,000 people a day. Says vice-president Yusuf Mehdi: "We've never been in a better situation to bring some heat to America Online."

Considering the turmoil at AOL Time

scribers surged 34% over the past 12 months. And analyst Ken Kiarash of the Buckingham Research Group predicts it will jump another 26% over the next year.

It's an awkward time for AOL to be playing defense. An accelerating switch to broadband Internet access could reshape the landscape. Analysts expect broadband users to triple to 32 million between now and 2005. Meanwhile, dial-up Internet access is expected to stall this year at 54.4 million households and then decline, according to researcher Yankee Group. Unless AOL can convince

With MSN 8 due out in the fall, Microsoft will for the first time leg up on AOL in features and fun. The new version offers photo editing and the Encarta digital encyclopedia—things AOL doesn't have—as well as improved parental controls and e-mail filters. "If you look at AOL by feature, AOL isn't as good as Microsoft," says analyst Charlene Li of Forrester Research Inc. To make that point, consumers, Microsoft is launching a series of "Pepsi vs. Coke" price promotions against AOL's advertisements.

Still, AOL denies that it's vulnerable. The company plans on launching its improved service this fall. While it won't divulge all the details, the new AOL will contain many of the same innovations as MSN 8, plus goodies such as Google search. A broadband version of AOL tuned to rival broadband connections is due out this year. AOL spokesman John Biscoffs at Microsoft's aspirations. "If checked, at its peak, 18 people sw

ONLINE WARS

MSN'S OFFENSIVE

SERVICE A new upgrade this fall will include such bells and whistles as photo editing, user-friendly spam filters, and parental controls

PRICE MSN's monthly dial-up runs \$21.95, vs. AOL's \$23.90, while broadband access runs \$39.95—\$5 less than AOL

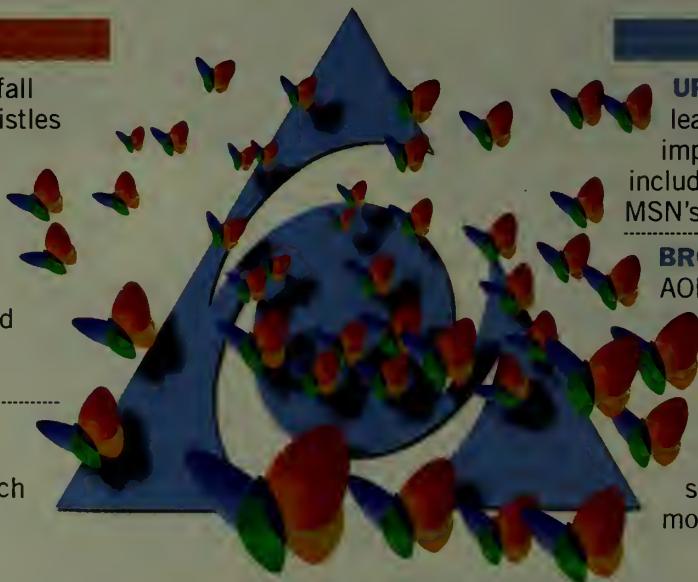
EASE A recent marketing campaign offers a simple way for AOL customers to switch over to MSN

AOL'S COUNTERATTACK

UPGRADES This fall, the market leader will roll out its own improved version, which will include new functions similar to MSN's, as well as better search tools

BROADBAND Later this year, AOL will launch a new broadband service that will allow improved streaming of music and movies

MUSIC AOL is also counting on a relaunched online music subscription service to attract more users next year



Warner, he's probably right. The AOL unit's second-quarter revenues dropped 3% from the same period a year ago, mostly due to an ad slump. AOL, with 26.5 million U.S. customers, is triple the size of MSN, but its growth of new subscribers has slowed to 13% over the past 12 months, down from 21% the previous year. The July departure under pressure of chief operating officer Robert W. Pittman, who had been the acting head of AOL, leaves the unit without a strong hand on the rudder. And now there's a federal investigation into its accounting.

While AOL is foundering, MSN is gaining strength. The number of MSN sub-

scribers to stick with it when they shift to broadband, it faces a massive loss of subscriptions.

Microsoft aims to take advantage of the broadband upswell. AOL has done little to sign up customers for broadband access—which number only in the hundreds of thousands for both companies. But Microsoft in June began offering MSN nationwide via broadband telephone lines. The price is \$39.95 a month, vs. AOL's fee of \$44.95. And starting later this year, MSN will be packaged with broadband offerings from Verizon Communications, Qwest Communications International, and other telephone carriers.

a day from AOL to MSN. Based on the year 3000, they may well be caught up," he says.

But AOL can't afford to take Microsoft lightly. Time after time, the software giant has matched the capabilities of rival's products and then its Windows monopoly and its vast horde to gradually gain market share. If AOL doesn't sort out its management problems and pick up the pace of innovation and marketing, its name will be added to the long list of those lost battles of attrition with Microsoft.

By Heather Green in New York
Catherine Yang in Washington

respond

recharge

refresh

rethink

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reveal

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STRATEGIES

AN OIL GIANT SPRINGS A LEAK

ChevronTexaco trails its peers—and has a Dynegy dilemma

On July 23, Dynegy Inc.'s troubles deepened as the energy trader yanked a \$325 million bond deal intended to shore up its finances and cut its cash flow expectations. With gas and power prices low and plenty of debt on its books, the company's \$800 million cash hoard has been declining quickly. The bad news drove the stock down 64%, to \$1.26 a share. And trading down along with it were the shares of its biggest supporter: ChevronTexaco.

For ChevronTexaco Corp., which owns a 26% stake in the company, the questions raised by Dynegy run deep. Most immediately, it's unclear what will happen to its \$2.8 billion investment,

especially if the trading house does run out of cash. That won't imperil ChevronTexaco, but it heightens questions about CEO David J. O'Reilly's decision last winter to pump an additional \$1.7 billion into the troubled concern.

More pressing are the questions the Dynegy debacle is raising about management's judgment. At a time when ChevronTexaco must convince analysts and investors that a much bigger and more complicated bet will pay off—the \$38 billion merger of Chevron and Texaco—support is eroding fast. “People are beginning to say these guys are not as shrewd or as good as

we thought,” says Fadel Gheit, an energy analyst at Fahnestock. “Dynegy definitely took some size of the stock.”

Last fall, when oil giant Chevron Corp. tied the knot with Texaco, little of this could have been expected. Dynegy was then seen mainly as a smart doorway into the energy trading business. At the time, the usually outspoken O'Reilly boasted confidently of the benefits the merger would bring. With \$100 billion in revenues, O'Reilly promised, ChevronTexaco Corp. “will be positioned for stronger financial returns than could be achieved by either company separately.”

But that promise has proven difficult to keep in the wake of Enron. In little less than a year later, ChevronTexaco not only finds itself wrestling with the usual problems of a multinational oil company—such as finding more oil and gas—but it's stuck with the Dynegy burden. The result? Chevron, once one of the most profitable Big Oil companies, has become a laggard.

Its return on capital is lowest among the five biggest integrated oil c

ChevronTexaco

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nies—five years after Chevron on its own was second-highest (chart). Its stock, recently at \$69, trades at a noticeable discount to its peers: 14 times 2002 expected earnings per share, vs. 16 times for BP PLC and 17 for Exxon Mobil Corp. Political unrest in West Africa and a fire that shut down production in mid-July threaten a critical region for the company.

The merger gave Chevron the bulk O'Reilly felt was needed to compete against larger rivals. But Texaco had a serious shortcoming: It had spent billions on international energy projects, yet was never able to boost oil and gas production as profitably as its peers. Says O'Reilly: "We knew when we put the two companies together the combined returns would be lower. The great opportunity is to capture the synergy between the two businesses." He says that is already happening. He expects his big exploration projects to pay off, while he slashes at costs during the integration.

O'Reilly has begun ChevronTexaco's turnaround with some aggressive cost-cutting. Chevron and Texaco had overlapping facilities in 14 major producing areas worldwide. At an investors' meeting in mid-June, O'Reilly said the company's expected savings from the merger would increase to \$2.2 billion a year by April, 2003, nearly double original estimates. O'Reilly is also cutting capital spending by 22%, to \$9.4 billion this year. All told, it should boost the company's return on capital two or three percentage points, bringing it more in line with peers.

Then comes the second stage of O'Reilly's strategy. Starting in 2004, he expects new oil and gas projects to give the company the sort of boost Chevron got in the '90s from its 9-billion-barrel Tengiz field in Kazakhstan. But to nudge growth of oil and gas revenues beyond the 1% increase he's projecting for this year and next, O'Reilly needs to get lucky. Part of his cost-cutting binge includes reduced spending on exploration. What he is spending will be focused on three key areas: More than half of ChevronTexaco's \$650 million exploration budget will be spent in the Gulf of Mexico and in the waters off Brazil and West Africa.

All three regions carry big risks. Chevron and Texaco each got a late start in the Gulf of Mexico, notes Richard G. Gordon, an analyst at John S. Herold Inc., an oil and gas invest-

ment firm. Even after the merger, ChevronTexaco still trails BP, Royal Dutch/Shell, and ExxonMobil in expected production from the gulf. No foreign company has yet had a major new field come on line in Brazilian waters. And while ChevronTexaco has had some success in West Africa, the region has become a headache recently. In mid-July, hundreds of women occupied the company's Escravos crude-oil distribution facility in Nigeria, demanding the construction of schools, clinics, and water systems. The protests, which coincided with an unrelated fire that shut

down production, underscored the difficulty of doing business in a country where local villagers have long felt they aren't sharing in the nation's oil riches. When asked what ChevronTexaco stands for, O'Reilly says: "We are a company that delivers on its commitments." Wall Street is saying that delivery seems a long way off.

But the collapse of Enron Co. has been bad news for all energy stocks, and Dynegy shares have fallen more than 90% on concerns of trading accounting shenanigans. Few see a chance of serious damage to ChevronTexaco, even if it has to write off

its \$2.8 billion Dynegy investment. But some wonder why O'Reilly hasn't done so already. Fahnestock Gheit estimates that a write-off would erase \$2.75 from its book value per share, minor compared to the \$26 a share the stock has dropped since early October, on concerns about Dynegy.

What worries Wall Street is that O'Reilly might sink more money into Dynegy or buy it outright, which would lower ChevronTexaco's return and could also bring legal liabilities stemming from the California electricity crisis. O'Reilly says he has decided which course to take. "The whole sector is struggling, but there is a business there," he says. "I'm not sure how it's going to play out."

O'Reilly's image on Wall Street remains as unclear as ChevronTexaco's future with Dynegy. The former department store manager from Dublin, Ireland, O'Reilly graduated from University College there with a chemical engineering degree, joined Chevron California in 1974, and made his mark running its troubled refining operation in the mid-1990s. By focusing on a few areas, like safety and customer service, he helped boost refining profits from \$75 million in 1995 to \$633 million three years later.

As CEO, however, O'Reilly has yet to spell out a management strategy that defines ChevronTexaco. ExxonMobil's Lee R. Raymond is seen as the strong, silent bull that always delivers industry-leading returns.

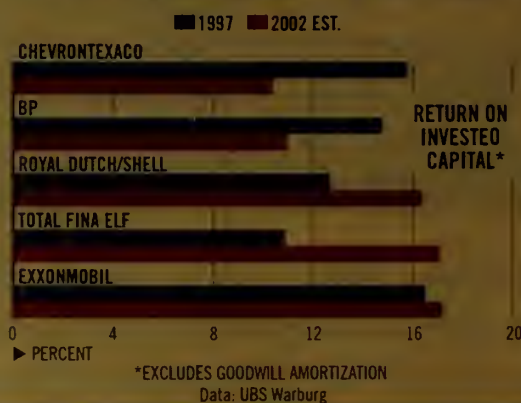
At BP, John Browne's reputation is that of an environmentally sensitive visionary. When asked what ChevronTexaco stands for, O'Reilly says: "We are a company that delivers on its commitments." Wall Street is saying that delivery seems a long way off.

By Christopher Palmeri in New York with Stephanie Anderson Foreman in Dallas



O'REILLY HAS HIGH HOPES—FOR 2004

ONCE A LEADER, NOW A LAGGARD

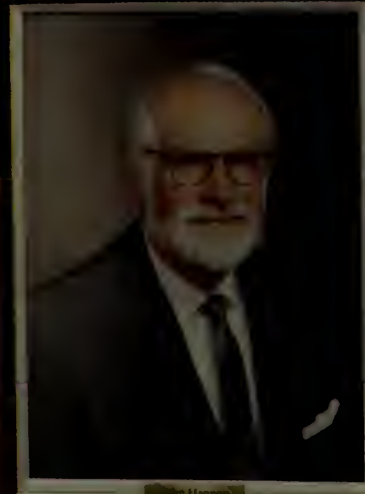
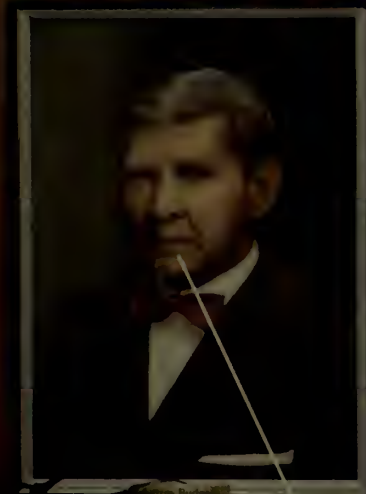


down production, underscored the difficulties of doing business in a country where local villagers have long felt they aren't sharing in the nation's oil riches.

Meanwhile, O'Reilly's commitment to Dynegy, in which Chevron first acquired a stake in 1996, continues to confound Wall Street. Despite the demise of Dynegy's online trading operation, O'Reilly is confident that there will always be op-

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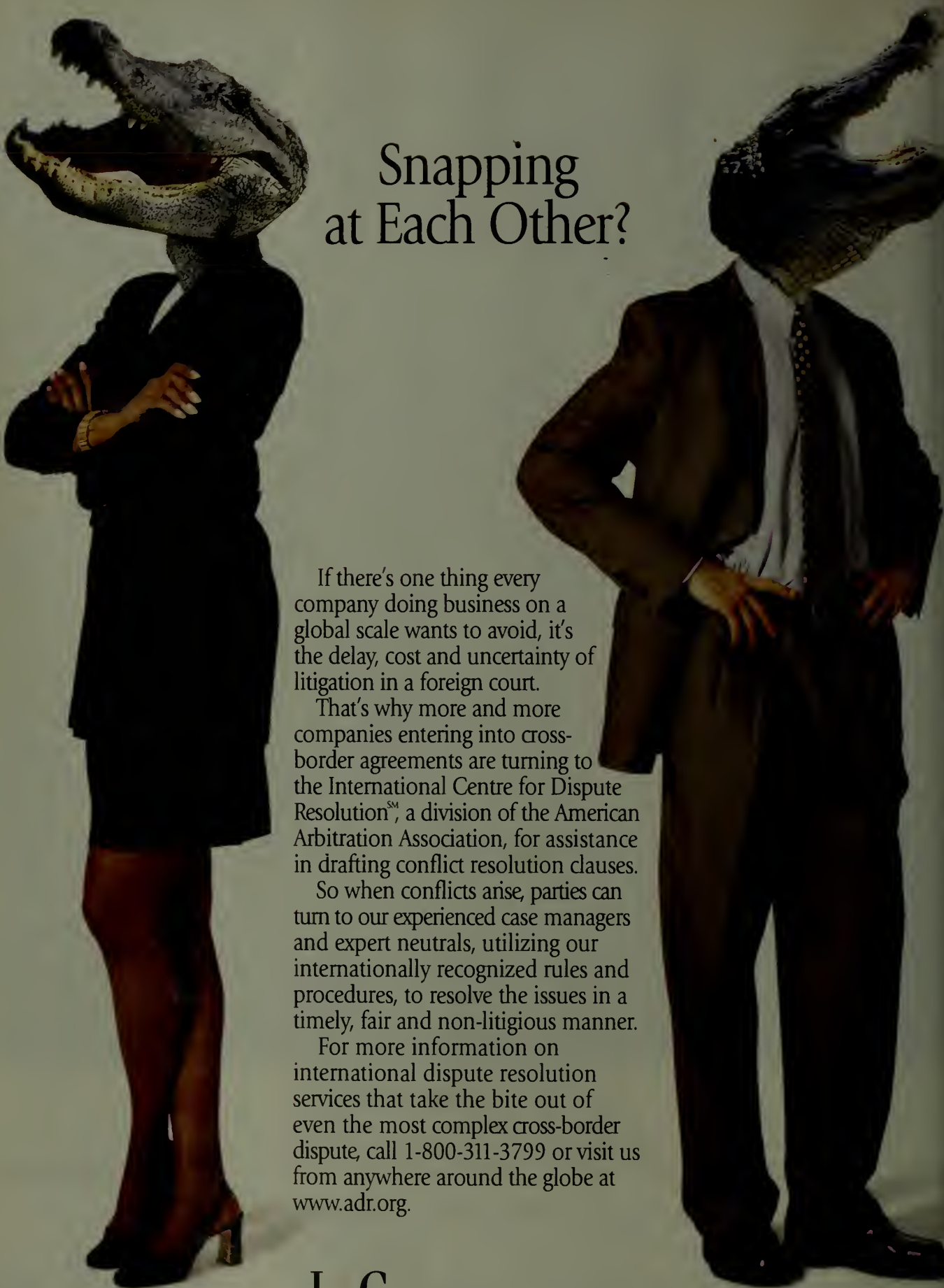
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International Centre
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COMMENTARY

By Peter Coy

THE AIRLINES: CAUGHT BETWEEN A HUB AND A HARD PLACE

Most of the big U.S. airlines are getting their wings yanked off. And it's not just because of the carnage of September 11 or the economic slowdown. In a June meeting with Wall Street analysts, American Airlines CEO Donald J. Carty said: "Everybody knows the industry's current pricing model is badly broken. Many of our customers feel that something dramatic needs to be done."

One critical problem: treacherous economics. The carriers' far-flung networks, in which dozens of "spoke" cities are served through a handful of "hub" airports. In good times, hubs enable the airlines to provide frequent service to many cities with short layovers. But the hub-and-spoke networks of United Airlines, American Airlines, Delta Airlines, and other big carriers are enormously expensive to run—and business travelers seem no longer willing to pay the high ticket prices that make them viable.

Change won't be easy. If hub airlines cut back too much, they will surrender the one advantage—service—they have over discount point-to-point carriers, such as Southwest Airlines Co.

Peter P. Belobaba, aeronautics professor at Massachusetts Institute of Technology: "It's very difficult to incrementally dismantle a hub."

The hub airlines' troubles have ominous implications for other financially stressed, deregulated industries that have high fixed costs, such as telecom and electric utilities. In each industry, serving additional customers is cheap once a network is in place. But price wars are endemic. Airlines, which were deregulated in 1978, have made some money by offering business travelers the high-

frequency connections they want, albeit at a high price. But if corporate purchasing departments are balking, it's not a good sign for the other high-fixed-cost industries that have been looking to boost profits.

In many ways, hubs are a great idea. A point-to-point airline could never make money on frequent service between, say, Syracuse and Richmond. But a hub airline can, by routing passengers through Newark or Detroit. It's easy for hub airlines to

to-point crews do because they have to wait for connecting flights. Hub airlines' labor costs wouldn't seem so high if they got more hours of useful work out of their employees.

The necessity of charging high fares makes hub carriers vulnerable to attack from both above and below. Some high-paid business travelers are turning to private jets, while the budget-conscious are switching to low-fare airlines, including point-to-point carriers. "What was a competi-

tive advantage in the '90s—hubbing—is becoming a competitive disadvantage," says Bert Wine-miller, CEO of Houston-based PROS Revenue Management, which sells fare-setting software to airlines.

Hub-and-spoke systems will never disappear entirely, because only they can provide frequent flights to many cities with short layovers. Even Southwest's chief financial officer, Gary C. Kelly, says: "I would concede that our approach is a niche approach."

But the hub airlines can't continue business as usual. To save money, they are likely to spread their flights out instead of concentrating them in banks, thus lengthening layovers. In the longer run, airlines will merge and close hubs. "There will be less service, and it will be less conven-

ient to travel," predicts Robert Crandall, the ex-chief of American Airlines, who created some of the first hubs. American is already experimenting in Chicago with scheduling flights more evenly, cutting congestion by building in longer layovers.

Corporate America's travel-and-expense accounts have paid for an impressive system of air transportation. As expense accounts shrink, airlines are the first losers. But the ultimate victims will be the traveling public.

With Wendy Zellner in Dallas

THE TOUGH ECONOMICS OF HUB-AND-SPOKE AIRLINES



TOO EXPENSIVE Requires lots of gates, staff, and planes to achieve good connections

OVERDEPENDENT ON BUSINESS TRAVEL Needs high-fare business passengers to justify expense of hubs

HARD TO SCALE BACK Cutting service can render hubs unattractive to business travelers

fill flights out of smaller cities because their planes carry passengers bound for anywhere in the world—not just one destination, as with a point-to-point airline.

But the blanket coverage comes at a price. To minimize layover times, hub airlines schedule lots of flights to arrive and depart within narrow windows of time called "banks." That requires leasing many gates and having lots of ground crew, who are idle between banks. Also, planes and their expensive flight crews spend more time on the ground than point-



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COMMENTARY

By Dan Carney

DON'T TOSS THIS STOCK-FRAUD LAW. JUST FIX IT

When Congress made it harder to sue companies for stock fraud in 1995, critics predicted catastrophe. The new law, said Senator Joseph R. Biden (D-Del.), would "give corporations a license to lie." Added Representative John D. Dingell (D-Mich.): "It would encourage the worst kind of misbehavior by people of great wealth."

Now, Biden and Dingell are leading the "I-told-you-so" caucus. Along with consumer groups, plaintiffs' attorneys, and a growing contingent of fellow legislators, they're calling for the repeal of the Private Securities Litigation Reform Act (PSLRA). While there isn't yet enough support to eliminate the law, opposition is growing with each new scandal. "We are now seeing the horrible effects that this law is having," says Representative Bart Stupak (D-Mich.), who sponsored a repeal bill in February.

But though it may be tempting to eliminate the PSLRA, the law didn't create the current mess we're in. The threat of getting sued by plaintiffs' lawyers has never been the main force keeping executives in check. And in truth, the PSLRA has hardly killed investor lawsuits. During the five years preceding the passage of the measure, shareholders filed 948 suits. In the five after, there were 935. And cases filed since the law was enacted have yielded some of history's biggest settlements, including suits against Cendant (\$2.8 billion), Waste Management (\$456 million), and 3Com (\$259 million).

Fact is, the PSLRA has done a pretty good job of weeding out abusive lawsuits while allowing meritorious ones to go forward. One of the most controversial provisions of the law, back when it was under debate in 1995, was a provision raising the "pleading standards" for new lawsuits. It required plaintiffs' attorneys to provide much more detail about an alleged fraud before a judge



would hear a case. But rather than slam the courthouse doors to innocent shareholders, as critics warned, this rule has simply forced investors' attorneys to bring better-researched cases. So the bottom line is basically that executives face just as much of a threat from securities-fraud litigation as they did before the 1995 law.

That's not to say the PSLRA is flawless. At a time when investors

are suffering enormous losses, it's too far in protecting the liability of the accountants, lawyers, and financiers who aid white-collar criminals. Under the PSLRA, these professionals are not, in most cases, on the hook for the full amount that shareholders lose. Rather, they are only "proportionately liable" for the percentage of losses directly attributable to the misconduct. That means that if a jury determined that Arthur Andersen LLP had, say, 25% of the responsibility for Enron Corp.'s collapse, the auditor would have to shell out a maximum of only one-quarter of damages in a fraud suit—a special protection generally not afforded elsewhere in the U.S. legal system.

This provision may sound technical, but it significantly decreased legal exposure of professionals who play a role in the commission of fraud. Prior to the PSLRA, accountants, lawyers, and investment bankers faced the prospect of holding the whole bag if a company they resented went bankrupt. Now, they face only a small fraction of that liability since the lion's share of blame for corporate failures is almost always assigned to the executives making the key decisions, not the outside advisers who help them. And don't think they're not aware of this when they give advice. "This has had a big impact on their willingness to push closer to the edge," says Henry T. Hu, law professor at the University of Texas at Austin.

Restoring the old rule would surely make the hired hands that advise Corporate America take their watchdog roles more seriously. And given all we have learned about corporate misbehavior recently, that's a must. But Congress would draw the wrong lesson from the recent scandal and the history of the PSLRA—if it decided to toss the legislation altogether.

Carney covers legal affairs for Washington.

STILL GOING STRONG

The 1995 Private Securities Litigation Reform Act (PSLRA) hasn't hurt investors as much as opponents claim.

Data: Stanford Law School, Cornerstone Research

THE NUMBER OF CASES HAS BARELY SLOWED...

NUMBER OF CASES FILED IN FIVE YEARS BEFORE PSLRA: **948**

NUMBER OF CASES FILED IN FIVE YEARS AFTER: **935**

...WHILE SETTLEMENTS ARE GROWING

PRE-PSLRA SETTLEMENTS AS A PERCENTAGE OF ESTIMATED SHAREHOLDER LOSSES: **5.1%**

POST-PSLRA **7.2%**



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BONDS

SO YOUNG

The 1990s saw a rash of flawed high-yield bond projects. Now, that bubble is bursting all over the U.S.

When city officials set out years ago to give Denver's downtown a lift, a "class" aquarium looked like just the ticket. Ocean Journey lured 1.2 million free-spending visitors a year. The best part: It wouldn't cost taxpayers much. Helped by its cash-rich status as a safe municipal issuer, the city had pulled in nearly \$60 million from investors by selling high-yield bonds that paid out from the box office.

Alas, for investors, low out-of-pocket costs, traffic, static exhibits, and high ticket prices meant the aquarium got only a third of the visitors it expected. In April, Ocean Journey filed for bankruptcy after city officials declined to bail it out. "We decided it was in the best interest of the city for the aquarium to proceed on its own," says John Gibson, Denver's director for financial management. Now, bondholders, including the Delaware Investments and the Nam Investments mutual-fund companies, are holding a soggy bag of restructuring may avert a shutdown but at best, they'll get a fraction of the expected returns.

Across the U.S., investors are getting similar shocks. During the boom, record \$150 billion in high-yield municipal bonds financed a building spree for aquariums, stadiums, toll roads, amusement parks, and housing projects. Unlike bonds backed by state or local taxes, they had no claim on public coffers. Yet investors disregarded the risks because of tax breaks associated with muni bonds and the perception that government issuers don't default.

Now, this high-yield muni bubble is bursting as the weak economy reveals the projects' flaws. A few cities have made revenue bondholders whole in the past—Tampa bailed out its struggling

WILD RIDE: This Birmingham (Ala.) park went bankrupt in June

DINK MUNIS ARE SAFE?

in 1996. But most say they support such projects now. In several Alabama communities let and, a three-year-old amusement nced by \$90 million in revenue le for bankruptcy.

biggest problems are toll roads. 0 major ones constructed since 1990s, nearly half carry far less an projected. Some \$4 billion in d bonds risk default over the e years unless they're refinanced, es Robert H. Muller, a municipal alyst at J.P. Morgan Securities ong the problem roads is the llion, 16-mile Southern Connector enville, S.C. Designed to steer oward some private developers' d projects, the road opened just recession hit in February, 2001. detour to avoid the \$1.50 toll, so

an half the projected commuters use it daily. blame consultants hired ss the projects. "There tory of feasibility stud- toll roads being overly tic," says John J. Halla- director of municipal research for Merrill & Co. Greenville officials e local economy will ally generate the traf- at Richard Few Sr., an of Connector 2000 which oversaw the financing and construc- onced that investors t get much in a default. ol of the road would re- to the state—not the olders.

istics are scarce, but treet pros estimate that ts of high-yield munis— are largely bought by al funds—jumped this rom 2% to 3% and are g up. That sounds small, e nearly 10 times the his- 0.3% default rate for tream munis backed by "There are going to be grenades, some definite o value that make you er what they were smok- hen they bought this,"

says Jeffrey M. Wilson, co-manager of Saybrook Capital LLC's Saybrook Tax-Exempt Opportunity Fund, who buys distressed muni bonds, betting on a restructuring.

While investors' losses in risky public projects may seem a pinprick compared with the trillions wiped off the value of stocks, the high-yield bond blowup bears close watching. The riskiest bonds may be the canary in the coal mine for the \$1.6 trillion municipal bond market. The nation's state governments' collective operating deficit will likely come in at nearly \$50 billion in the fiscal year ended June 30, 2002, vs. a \$23.9 billion surplus in fiscal 2001. California faces a staggering \$25 billion deficit in its 2002-2003 budget. This year, Standard & Poor's has downgraded New Jersey, Wisconsin, and Colorado debt, and put

four other states on negative outlook. "We think it's going to be a pretty difficult environment for the states," says Robin L. Prunty, a director at S&P's public finance ratings department. "I see very little upside."

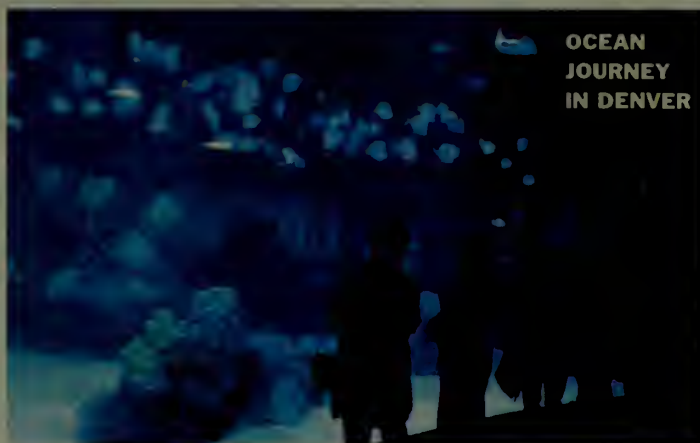
Unfortunately, small investors don't see it that way. Panicked by their stock losses, they're blindly pouring money into the perceived safe haven of muni bonds. A record \$320 billion is expected to come into munis this year. And analysts think investors are becoming less discriminating about risk just as they should be on high alert.

The demand for all types of muni bonds has raised prices and lowered yields across the board. It has also narrowed the yield spread between high- and low-quality bonds. For example, Hallacy notes, over the past year, yields on 10-year California state bonds, which only carry an A+ rating, have dropped from 38 basis points above the average yield for AAA bonds to 8 basis points below it. The wider use of bond insurance is one reason why lower-quality issues carry a smaller risk premium than they once did. But analysts also think investors are ignoring potential credit problems.

To be sure, there are only a few cases of public defaults on investment-grade munis—New York City in 1975 and the Washington Public Power Supply System in 1983 being the most notorious. Governments can, in theory, always raise money through taxes. Yet analysts fear that investors, who mistakenly believe that their capital is safe, could lose lots of money if issuers are downgraded and the prices of weaker issues plunge.

Many investors are still desperately seeking a safe haven from the misery of the stock market. But the public sector can offer only so much succor. After all, it's only as financially solid as its citizens. And most feel pretty shaky right now.

By Dean Foust
in Atlanta



BAD PLANNING

Many projects that pay bond investors out of their revenues are in trouble

TOLL ROADS Cities in South Carolina, Florida, and California built them to serve real estate projects of politically connected developers. Traffic often misses projections, and road operators are careening toward default.

AQUARIUMS Denver, Tampa, and Duluth, Minn., among others, erected aquariums to draw tourists. The Duluth project took out a bank loan to meet bond payments in June. In Denver, unchanging exhibits stymie repeat business.

HOUSING Many cities underestimated the costs of renovating rundown apartments for low-income housing, and many tenants preferred private units. Default rates average 5%—15 times higher than munis overall.

ACQUISITIONS

POLAROID: A SWEET DEAL

Bank One is set to land it for a song, but critics are crying foul

Superficially, Polaroid Corp. has all the market appeal of one of its quaint instant cameras. But as the hot tech company of the 1960s and '70s emerges from bankruptcy, it's turning out to be one of the year's best bargains, with a trove of assets that are going for cents on the dollar.

On June 28, the U.S. bankruptcy court in Delaware approved the sale of a 65% stake in Polaroid to One Equity Partners, a private equity unit of Chicago's Bank One Corp., for \$255 million. (Unsecured creditors get 35%.) But Polaroid has more than \$1 billion in assets—including real estate, art, and foreign holdings—that are either undervalued or not valued at all in filings.

The deal is a steal for OEP. Most of the price is a promise to pay off \$228 million in Polaroid debts. The money will come mostly from the \$215 million in cash Polaroid held at the end of May. OEP will only put in about \$60 million. Shareholders get zip, and many retirees' checks will shrink when the government takes over Polaroid's pension plan.

OEP's first offer was even more self-serving: It gave unsecured creditors, whom Polaroid says it owes \$887 million, a mere 5% stake. After the creditors told Judge Peter J. Walsh that Polaroid was doing better than forecast and OEP was paying peanuts, OEP raised its offer to 35%.

Still, many critics want a new auction. "The sale is a scandal," says Ulysses A. Yannas, an analyst at Buckman, Buckman & Reid Inc., who doesn't own shares. A group of retirees has asked Walsh and Mark Kenney, the U.S. bankruptcy trustee, to reopen the bidding. Kenney says he has no plans to do so. Unless Walsh reverses himself or an ap-

peal voids the sale, OEP will be Polaroid's new owner.

OEP won't comment. But Polaroid clearly is no longer the disaster it was in October. Then, a 10-year slide in instant-film sales finally crippled the 65-year-old company's ability to pay down its \$950 million in debt and it declared bankruptcy. In the five months through May 31, it earned \$16.8 million before interest, taxes, depreciation, amortization, and restructuring charges.

The \$714 million of assets Polaroid showed in its bankruptcy filings were only part of the story. In its final quarterly statement to the Securities & Exchange Commission last year, the company listed \$1.8 billion of assets. What's the difference? Polaroid changed its accounting to list

only assets with book values it could verify, eliminating foreign assets. CFO L. Flaherty said market vagaries made it impossible to do otherwise. Judges agreed, saying prospective buyers had to decide what the assets were worth.

As a result, it takes some sleuthing to find out what Polaroid has.

A: Its 108-acre property in Norwood, Mass., where 250 employees make instant film. The bankruptcy filing values it at \$100 million, but the town of Norwood appraised it at nearly \$34 million. Bankholder Stephen J. Morgan says the

company's public assessments

of Polaroid's real estate are worth \$144 million.

Foreign

assets, including factories in

China, Mexico, and the

Netherlands.

Assets in Scotland, and

others not valued at all,

though Polaroid said in its

filings that the value of

these "lived" foreign

assets were

\$154 million.

The photo collection

includes

by Walter

Wegman.

Ansel Adams

was given

an "undetermined" value.

meantime, Polaroid is developing a new, low-cost instant digital-printing technology, which former CEO Gary T. DiCamillo says could generate \$1 billion in sales over the next five years.

Despite its latent value, Polaroid attracted little interest among the 17 investment bankers contacted by Eastman Kodak Co. and Fuji Photo Co. executives visited but did not bid, sources close to the company say. The only bidder, Deutsche Bank, withdrew, possibly put off by Polaroid's shaky business prospects. Instant film is an endangered species, with sales expected to drop for the foreseeable future. It takes millions before the new digital-printing technology is ready.

Still, Polaroid retirees and shareholders say they're getting the shaft. "It's another example in the making of today's well-publicized corporate reorganization and infectious greed," retired D. Gignac, who claims to represent pensioners, wrote Judge Walsh.

With so many high-profile bankruptcies under way, OEP's deal proves there's plenty to fight over. Even at the undervalued companies.

By Geoffrey Smith in 1



OEP'S SPOILS: Polaroid's property in Norwood, Mass. and its new digital photo-finishing system

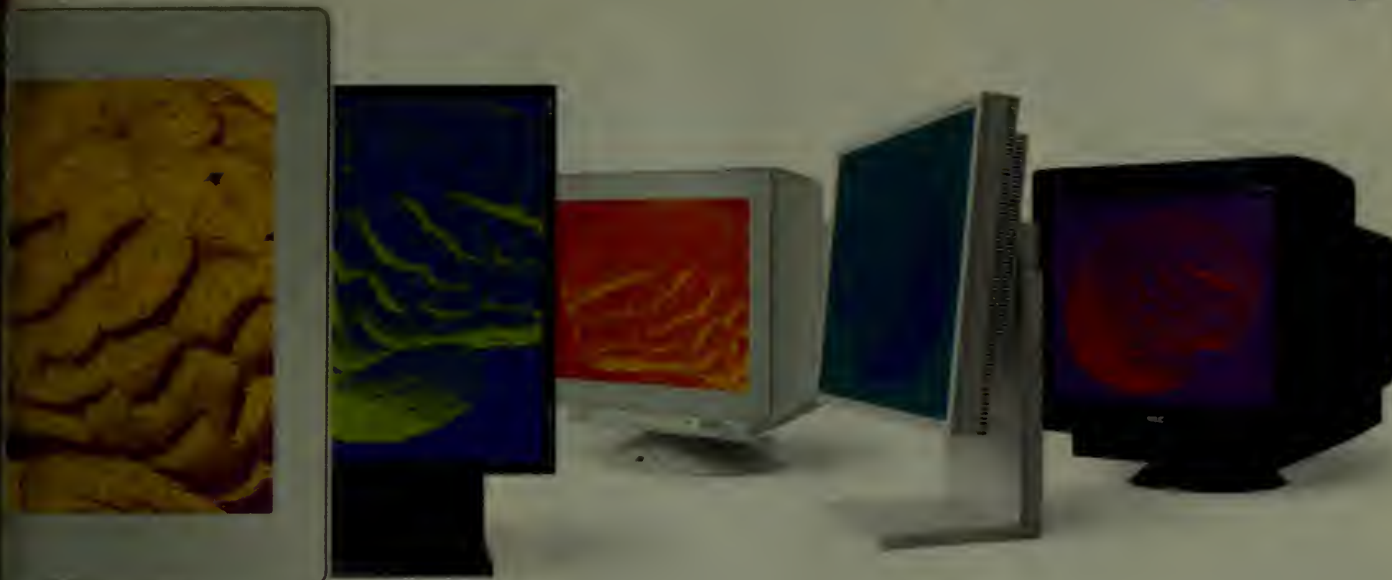
INSTANT RICHES

Bank One's purchase of bankrupt Polaroid for \$255 million looks like a steal. What the bank gets:

- \$214 million in cash
- A 65% stake in a profitable business and new printing technology
- U.S. assets worth at least \$714 million
- Foreign assets worth at least \$154 million

Data: Polaroid, bankruptcy court filings

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THE BEST GLOBAL BRANDS

BusinessWeek and **INTERBRAND** tell you what they're worth

Wireless phones. Consumer electronics. Memory chips. Could you pick three tougher lines of business to be in right now? Somehow, with just such a portfolio, Samsung Electronics Co. managed to more than double its profits in the most recent quarter, to \$1.6 billion.

How? Once a humdrum manufacturer of commodity electronics largely sold under other companies' names, South Korea-based Samsung is reaping the rewards of moving aggressively into higher-end products that carry fatter profit margins. It has invested heavily to produce cutting-edge designs, from flat-panel TV monitors that can be hung on walls like paintings to an elegantly thin DVD player. The company moved up the memory-chip price chain to sell more devices to video game makers. And it became the No. 3 producer of cell phones, with a premium-priced line that includes handsets with color screens.

But just as critical as the turnover in product was the face-lift Samsung gave its brand. Last year, it took a first stab at creating a new image with visually arresting ads such as

one that posed an impossibly stylish woman in blue makeup, yellow nail polish, and ostrich feathers next to one of its monitors. This year, it plans to spend \$200 million on a campaign focused on the company's promise to provide a "DigitAperience." That's an attempt to drive home the link between Samsung's new upscale image and the lifestyle its customers crave, says Eric B. Kim, executive vice-president for marketing operations. Says Kim: "This is our first attempt to be at the leading edge rather than being a follower."

Now more than ever, companies see the power of a strong brand. At a time when both investors, customers, and employees are questioning the proven value flows straight to the bottom line. If, shaken by the plummeting stock market and concerned about the security of their jobs, consumers start cutting back on spending, they're more likely to stick with names they know and trust. "When a brand earns our trust, we not only buy from our purchases, but we also tell all of our friends about it," says David Martin, U.S. president of New York-based

Special Report



l Corp., a pioneering brand consultant that teamed up with *BusinessWeek* to create our second annual ranking of the world's most valuable global brands.

Brands usually aren't listed on corporate balance sheets, so they can go further in determining a company's success than a new factory or technological breakthrough. That's the beauty of having a strong brand, even in bad times, can allow companies to command premium prices. Purveyors of products from Budweiser beer to BMW cars have been able to grow without succumbing to the pressures of an intensely promotional environment. A strong brand also opens the door when growth depends on moving into new markets. Starbucks is among the fastest-growing brands, having set up shop in Vienna, one of Europe's café capitals, and says 400 of its 1,200 new store openings this year are overseas.

Sort out which global brands are holding their ground and which are crumbling. Interbrand and *BusinessWeek* created this ranking of the top 100 by dollar value. The list by Interbrand, a unit of Omnicom Group Inc., is based on the idea that strong brands have the power to lift earnings. Interbrand attempts to figure out how much of a boost each brand delivers, how stable that boost is likely to be, and how much those future gains are worth today. The value that is assigned is strictly for the products with which the brand is associated, not for others sold by the company. Therefore, Coca-Cola Co.—the top brand again this year, with a value approaching \$70 billion—is ranked just on those products carrying the Coke name, not Sprite or Powerade.

Because Interbrand relies on a rigorous analysis of cash flows rather than mere consumer perceptions to calculate brand values, changes in the business climate or a category's fortunes can have a strong impact on those values. An economic downturn can erode values even among companies that have resisted the temptation to cut marketing budgets, raise prices, or compromise on quality. In today's perilous eco-

nommic climate, it's no surprise, then, that 49 out of the 100 brands on our list—and 7 of the top 10—fell in value this year. That compares with 41 that dropped in value in our 2001 ranking. Some of the hardest-hit brands represent industries—telecommunications, finance, travel, and luxury goods—that have been body-slammed by the downturn.

Take Boeing Co., whose ambitious brand-influencing efforts—from advertising to relocating its headquarters from Seattle to Chicago—helped put it on the list last year at \$4 billion. But September 11's devastating impact on air travel almost instantly put on hold airlines' plans to expand their fleets, causing Boeing's hard-won brand value to plunge 27% this year, to \$3 billion—a billion dollars of value wiped out.

Still, some companies compounded the problems of a down economy with management missteps. AT&T plunged 30% in value, losing its place among the top 10 brands. The company spent hundreds of millions on aggressive, youth-oriented ads and upgraded the range of licensed products that bear the AT&T name in order to shed its stodgy Ma Bell image. But it didn't deliver enough exciting new products and services fast enough to sell customers on a "new" AT&T.

Amid the carnage, though, many companies found ways to add value to their brands. Samsung was easily the fastest-growing, its value rising an estimated 30% to \$8.3 billion. While Coke continues to struggle to get back its rhythm in the U.S., its sales are still growing in the developing world, buttressed by a strong

global marketing effort behind the World Cup. Thus, Coke eked out a 1% gain, adding \$700 million in brand value. Despite losing some highly publicized battles in the courtroom over its tobacco liability, Philip Morris Cos. saw its venerable Marlboro brand push into the Top 10, adding 10% to its value. The company used deep pockets to squeeze rival brands out of prime display positions in stores.

Other winners exploited their strong brands by launching extensions into new products and categories. Too often, new fla-

The World's 10 Most Valuable Brands

RANK	BRAND	2002 BRAND VALUE (\$BILLIONS)
1	COCA-COLA	69.6
2	MICROSOFT	64.1
3	IBM	51.2
4	GE	41.3
5	INTEL	30.9
6	NOKIA	30.0
7	DISNEY	29.3
8	MCDONALD'S	26.4
9	MARLBORO	24.2
10	MERCEDES	21.0

Data: Interbrand Corp., J.P. Morgan Chase & Co.

vors, formulations, and packages wind up as barren exercises in market positioning that clog retail shelf space while offering consumers nothing truly different. But this year's ranking offers proof that the right line extensions can make a difference. H.J. Heinz Co. boosted its brand value by 4% with ingenious ways of driving consumer interest in ketchup, from squeezable bottles to versions spiced up

with flavors such as Smokey Mesquite. Diageo PLC's onetime Smirnoff vodka brand scored a 5% gain thanks to the success of a citrus-flavored, single-serve drink, Smirnoff Ice. Positioned as a sophisticated alternative to beer, Ice not only became a hit with younger consumers but also enticed them into giving a second glance to the core brand, which got a lift.

The Nivea skin-care line shows how to strengthen a brand by branching out. Beiersdorf went further than a line extension or two in garnering a 16% brand-value rise for its unit. Starting with women's skin-care products and a carefully nurtured image of wholesomeness and natural ingredients, Nivea has moved into men's products, including deodorants, shampoos, and even a moisturizer dispensed from an electric razor. Nivea has dozens of products today, vs. a handful five years ago. "They are a classic example of how far you can go

SAMSUNG Heavy investment in design R&D has brought fatter profit margins

Winners

Samsung used bold designs to transform itself into a premium seller of consumer products.

Baby boomers, meanwhile, pay Harley top dollar for a dash of rebel independence.

RANK	BRAND	2002 BRAND VALUE (\$BILLIONS)	2001 BRAND VALUE (\$BILLIONS)	% CHANGE
34	SAMSUNG	8.3	6.4	+30
91	NIVEA	2.1	1.8	+16
46	HARLEY-DAVIDSON	6.3	5.5	+13
31	DELL	9.2	8.3	+12
93	STARBUCKS	2.0	1.8	+12

Data: Interbrand Corp., J.P. Morgan Chase & Co.

Losers

The telecom debacle cut the legs out under Ericsson and AT&T. Boeing still recovered from September 11, and Merrill Lynch got mauled by the bear market.

RANK	BRAND	2002 BRAND VALUE (\$BILLIONS)	2001 BRAND VALUE (\$BILLIONS)
71	ERICSSON	3.6	7.1
11	FORD	20.4	30.1
17	AT&T	16.1	22.8
82	BOEING	3.0	4.1
25	MERRILL LYNCH	11.2	15.0

Data: Interbrand Corp., J.P. Morgan Chase & Co.

increase in brand value is so impressive. The PC maker's promotional ads an additional brand-building role. They an enthusiastic young character, "Steven," congratulates customers with "Dude, you're getting a Dell!"—driving home the point that customers can get exactly what they want at prices. After years of making that point in a dry way, Steven brought "real personality to Dell," says Scott Helbing, the

DELL The enthusiastic "Steven" of recent ads helped boost the brand's value 12%

company's vice-president for global brand strategy.

But ads can take a brand only so far. And if their claims are not backed up by performance, the ads erode value. For that reason, employees are a crucial part of the consumer. If employees are motivated to reflect the brand values in all their activities, that radiates out to customers, and on to friends and family in word-of-mouth endorsements—which in the Internet era can circle the globe instantly. Brand winners "have inculcated what's great about their companies up and down the organization," says Scott Bedbury, a former top manager at Nike Inc. and Starbucks who now works as a consultant Brandstream in Seattle.

Even the best corporate names are under attack these days. Still, those companies reaping the benefits of years they spent building customer trust and honing image for quality and dependability. To weather the extended bout of distrust and instability, brands are crucial. Companies also will have to work doubly hard to keep them intact.

By Gerry Khermouch in New York

BusinessWeek online

For a video discussion of brand value and an interactive version of our scoreboard, go to the Aug. 5 edition online at www.businessweek.com



THE 100 TOP BRANDS

What's in a name? Plenty, if you play your cards right

was a tough year to build a brand—or defend one against the corrosive effects of a bear market, financial scandals, and shifting consumer priorities. For proof, look no further than the fact that roughly half of the 100 global brands that Interbrand Corp. and *BusinessWeek* ranked this year fell in value compared with a year in this environment, just holding your own is an accomplishment.

To qualify for our ranking, brands had to have a value of more than \$1 billion. They were selected according to two criteria: They had to be global in nature, deriving 20% or more of sales outside their home country. They also had to have publicly available marketing and financial data on which to base the valuation. We excluded some big brands, such as Visa International, McDonald's, and Mars.

How do you place a value on a brand? Some attempts are little more than opinion polls or ad spending. *BusinessWeek* selected Interbrand's method because it values brands the same way analysts value other assets: on the basis of how much they're likely to earn in the future. Those projected profits are then discounted to a present value based on how risky the projected earnings are—that is, the likelihood that they will in fact materialize.

To start the process, Interbrand first figures out what

percentage of overall revenues are accounted for by the power of the brand. Next, with the help of analysts from J.P. Morgan Chase & Co., Interbrand projects net earnings for that segment of the business. Interbrand then deducts a charge for the cost of owning the tangible assets, on the theory that whatever income is generated beyond that cost is due to intangible factors. This is the economic value added by things like patents, customer lists, and, of course, the brand.

The next step is to winnow the earnings generated by the brand from the earnings generated by other intangibles. For example, are people buying Shell gasoline because of the brand name or because the gas station is conveniently located? Interbrand uses market research and interviews with industry executives to sift through those variables.

The final phase is to analyze the strength of the brand to figure out how risky those future brand earnings are. To calculate the brand's strength, Interbrand looks at seven factors, including the brand's market leadership, its stability, and its ability to cross geographical and cultural borders. The risk analysis produces a discount rate that is applied to the brand earnings to come up with a net present value of the brand. *BusinessWeek* and Interbrand believe this figure comes closest to representing the true economic value of that complex array of forces that make up a brand.

Special Report

The Global Brand Scoreboard

	2002 BRAND VALUE \$BILLIONS	2001 BRAND VALUE \$BILLIONS	PERCENT CHANGE	COUNTRY OF OWNERSHIP	DESCRIPTION
COCA-COLA	69.64	68.95	+1%	U.S.	Still the best brand by far. Growth in the developing world offset so-so new products like Diet Coke with Lemon.
MICROSOFT	64.09	65.07	-2	U.S.	Its name is still dragged through the courtroom, but the biggest challenge is stagnant PC purchases.
IBM	51.19	52.75	-3	U.S.	Good thing Big Blue was rebuilt on services, which remains the most promising segment for tech spending.
GE	41.31	42.40	-3	U.S.	The retirement of Jack Welch and angst over Corporate America took a toll on the GE name.
INTEL	30.86	34.67	-11	U.S.	"Intel Inside" put it on the map, but now the brand faces tough competition and sluggish PC sales.
NOKIA	29.97	35.04	-14	Finland	Still the cell-phone brand of choice among consumers, but overall sales of mobile handsets are weak.
DISNEY	29.26	32.59	-10	U.S.	Even monster hit <i>Monsters Inc.</i> couldn't compensate for a post-September 11 falloff at theme parks.
MCDONALD'S	26.38	25.29	+4	U.S.	Who remembers Mad Cow disease? Global expansion continues as negative PR fades.
MARLBORO	24.15	22.05	+10	U.S.	The iconic brand uses line extensions and merchandising clout to overcome court challenges and skyrocketing price of cigs.

Data: Interbrand Corp., J.P. Morgan Chase & Co., *BusinessWeek*

The Global Brand Scoreboard

RANK	2002 BRAND VALUE \$BILLIONS	2001 BRAND VALUE \$BILLIONS	PERCENT CHANGE	COUNTRY OF OWNERSHIP	DESCRIPTION
10 MERCEDES	21.01	21.73	-3	Germany	The leading luxury car brand, but its low-end models suffered from reviews.
11 FORD	20.40	30.09	-32	U.S.	At least Ford admitted to pursuing strategies that were "poorly conceived or poorly timed." But where's the fix?
12 TOYOTA	19.45	18.58	+5	Japan	Cruising along after capturing broad mid-market appeal in the U.S. including new SUVs and pickups.
13 CITIBANK	18.07	19.01	-5	U.S.	A slowing U.S. economy and a hit from the Enron fiasco hurt both and image.
14 HEWLETT-PACKARD	16.78	17.98	-7	U.S.	More and more, its printers are commodities. Bickering during the paq merger also didn't boost HP's image.
15 AMERICAN EXPRESS	16.29	16.92	-4	U.S.	Wary U.S. consumers, penny-pinching corporations, and white-hot titillation in credit cards made it a tough year for the prestigious brand.
16 CISCO	16.22	17.21	-6	U.S.	The popping of the Internet bubble, and the plunge in telecom spending drew down brand value.
17 AT&T	16.06	22.83	-30	U.S.	Nobody loves telecom these days. But at least it's faring better than WorldCom.
18 HONDA	15.06	14.64	+3	Japan	Solid, dependable, and nurturing a growing reputation for earth-friendly "hybrid" technology.
19 GILLETTE	14.96	15.30	-2	U.S.	The King of Blades is still gaining share, as higher marketing boosted premium Mach 3 and Venus razors.
20 BMW	14.43	13.86	+4	Germany	Bold new designs—from the space-age 7-series sedan to the athletic SUV—helped BMW boost sales and profit margins.
21 SONY	13.90	15.01	-7	Japan	Still known for its design flair, Sony gadgets have come under attack from Samsung.
22 NESCAFE	12.84	13.25	-3	Switzerland	Cheap instant coffee is losing favor as people consume more java at the home.
23 ORACLE	11.51	12.22	-6	U.S.	Look out below: Oracle's value has eroded along with tech spending.
24 BUDWEISER	11.35	10.84	+5	U.S.	Nimble advertising for Bud and soaring Bud Light gives it continued inance in the U.S. and U.K.
25 MERRILL LYNCH	11.23	15.02	-25	U.S.	Investors have long memories, so Merrill's conflict-of-interest fiasco between bankers and analysts could linger.
26 MORGAN STANLEY	11.20	N/A	N/A	U.S.	Few on Wall Street emerged unscathed from the earnings controversy. Morgan Stanley also had a poor performance underwriting IPOs.
27 COMPAQ	9.80	12.35	-21	U.S.	A big grab for market share by Dell, coupled with the histrionics over Compaq's merger with HP, hurt a tired brand.
28 PFIZER	9.77	8.95	+9	U.S.	Pfizer took the high ground on a hot-button issue with initiative to sell reduced-price drugs.
29 J.P. MORGAN	9.69	N/A	N/A	U.S.	The market was bad enough, but J.P. Morgan also had big negative sure in the Enron collapse.
30 KODAK	9.67	10.80	-10	U.S.	Kodak so far hasn't transferred the equity from its longtime dominant photo into the digital market.
31 DELL	9.24	8.27	+12	U.S.	Proved that its built-to-order business model works in bad times as good.
32 NINTENDO	9.22	9.46	-3	Japan	On top of the price battle faced by its GameCube, the handheld Game Boy Advance was only a middling success.
33 MERCK	9.14	9.67	-6	U.S.	Vioxx faces patent expiration and new-drug pipeline is dry. Now, investors are ill over accounting questions.
34 SAMSUNG	8.31	6.37	+30	S. Korea	Revved up brand value with brilliant product design and arresting marketing.
35 NIKE	7.72	7.59	+2	U.S.	Strides in penetrating soccer market, and signs it may do the same golf, augur well for this premium brand.
36 GAP	7.41	8.75	-15	U.S.	Its slide accelerated as consumers turned elsewhere for cutting-edge styles or lower prices.
37 HEINZ	7.35	7.06	+4	U.S.	A classic brand that exploits core markets with memorable extensions everything from ketchup to tuna.
38 VOLKSWAGEN	7.21	7.34	-2	Germany	Global car sales are down, and the new Beetle was not the megahit might have hoped for.
39 GOLDMAN SACHS	7.19	7.87	-9	U.S.	CEO Henry Paulson spoke out about declining corporate credibility, far it hasn't rubbed off on the Goldman brand.

Data: Interbrand Corp., J.P. Morgan Chase & Co., *BusinessWeek*



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The Global Brand Scoreboard

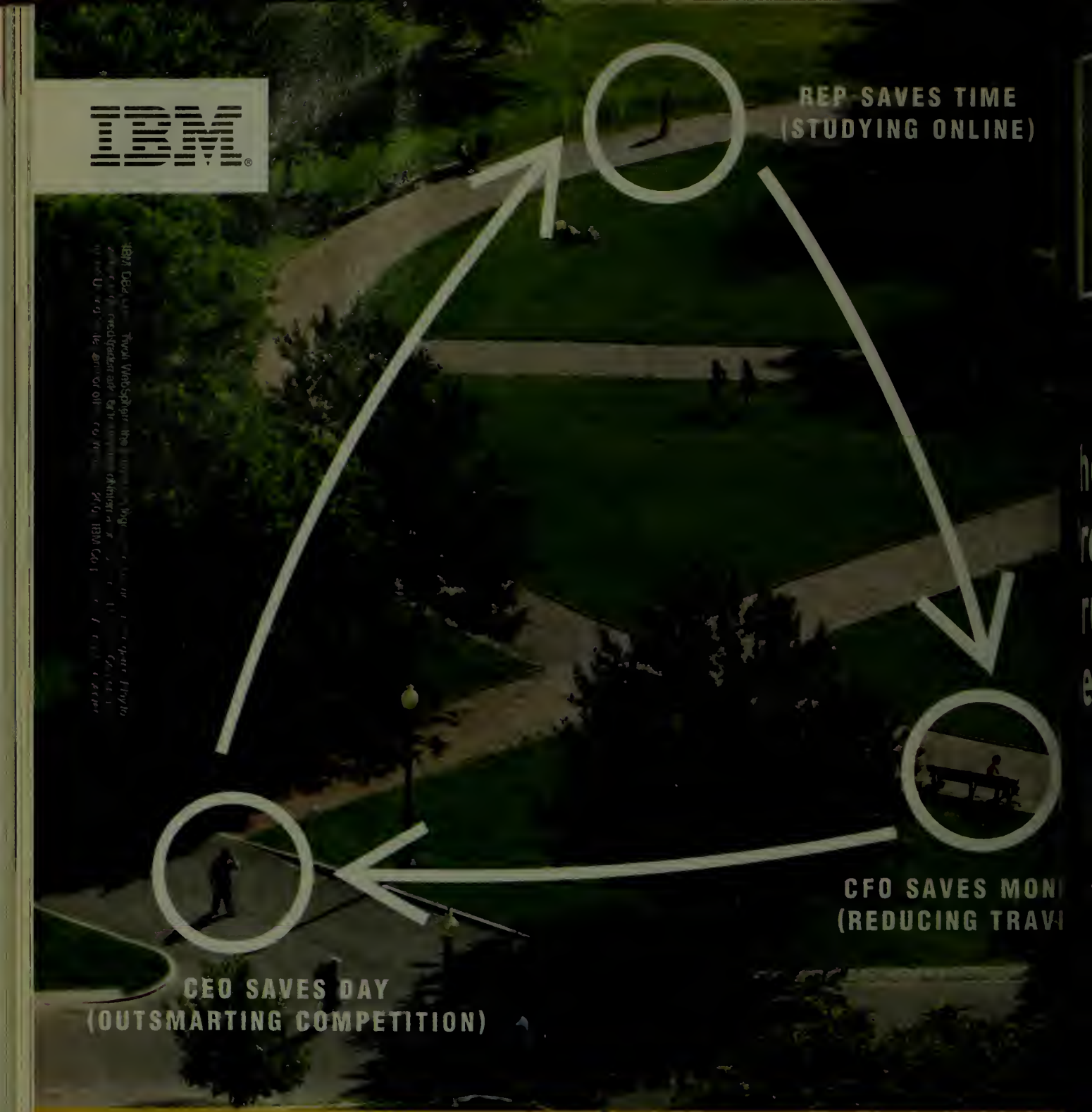
RANK	2002 BRAND VALUE \$BILLIONS	2001 BRAND VALUE \$BILLIONS	PERCENT CHANGE	COUNTRY OF OWNERSHIP	DESCRIPTION
40 KELLOGG'S	7.19	7.01	+3	U.S.	Stabs at innovation, and a Disney alliance that put Buzz Lightyear real boxes, renewed the brand's relevance.
41 LOUIS VUITTON	7.05	7.05	0	France	Still a fashion must-have, particularly in Asia, but sales have been hurt because of post-September 11 travel decline.
42 SAP	6.78	6.31	+7	Germany	SAP has delivered on theme, "The best-run e-businesses run SAP" software maker benefited from a flight to established suppliers.
43 CANON	6.72	6.68	+2	Japan	A reasonable performance in a camera market that is exhibiting a growth. And it's gaining on Xerox in copiers.
44 IKEA	6.55	6.01	+9	Sweden	Resonant brand benefited from the weak economy, which made more customers willing to assemble their own tables.
45 PEPSI	6.39	6.21	+3	U.S.	Innovations keep coming, like lemon-flavored Pepsi Twist. But big challenge is a consumer shift to bottled water and juices.
46 HARLEY-DAVIDSON	6.27	5.53	+13	U.S.	Masterful job of selling Baby Boomers on a high-margin symbol of youthful rebellion.
47 MTV	6.08	6.60	-8	U.S.	Phenomenal success of <i>The Osbournes</i> shows MTV still has its spunk. Unfortunately, the ad market is dead.
48 PIZZA HUT	6.05	6.00	+1	U.S.	Tough market, but the chain upgraded its restaurants and added new products like P-Zone, Twisted Crust, and Quad.
49 KFC	5.35	5.26	+2	U.S.	Introduced Popcorn Chicken, new Chicken Twister sandwich, and new restaurants co-branded with corporate sibling Pizza Hut.
50 APPLE	5.32	5.46	-3	U.S.	A well-received new iMac couldn't overcome weak sales to consumer design professionals.
51 XEROX	5.31	6.02	-12	U.S.	Trying to dodge its stodgy image, with digital and high-speed copiers, but a financial cloud lingers.
52 GUCCI	5.30	5.37	-1	Italy	The ongoing allure of lead designer Tom Ford could offset a slow sales decline in 2002.
53 ACCENTURE	5.18	N/A	N/A	U.S.	In light of former parent Arthur Andersen's fate, Accenture's brand new initiative looks like sheer brilliance.
54 L'OREAL	5.08	N/A	N/A	France	No slowdown here. The brand now gets more than half its sales outside Europe, thanks to smart acquisitions.
55 KLEENEX	5.04	5.09	-1	U.S.	Kleenex held most of its value because of innovations like Kleenex facial tissues, for car door pockets.
56 SUN	4.78	5.15	-7	U.S.	Sun still leads in servers, but must deal with the implosion of the once-fertile dot-com sector.
57 WRIGLEY'S	4.75	4.53	+5	U.S.	Innovations kept the Wrigley's brand fresh. Can "functional" products like tooth-cleaning gum add further shine?
58 REUTERS	4.61	5.24	-12	Britain	Reuters lost considerable ground to Bloomberg as customers fled its old-fashioned image and poor service.
59 COLGATE	4.60	4.57	+1	U.S.	A toothpaste/mouthwash combo and other novelties helped offset a decline in share in other product areas.
60 PHILIPS	4.56	4.90	-7	Netherlands	Potent in Europe but weak in North America, this brand was dogged by tough consumer-electronics markets and lackluster U.S. marketing.
61 NESTLE	4.43	N/A	N/A	Switzerland	The king of chocolate, cookies, and baby food is eating up U.S. ice cream with Dreyer's.
62 AVON	4.40	4.37	+1	U.S.	A makeover of its sales force and product lines boosted U.S. sales. Avon has stumbled with its foray into retail sales.
63 AOL	4.33	4.50	-4	U.S.	Few signs of promised synergies following merger with Time Warner. AOL's subscriber growth has slowed.
64 CHANEL	4.27	4.27	0	France	The perfume and fashion icon held its own in a tough global economy.
65 KRAFT	4.08	4.03	+1	U.S.	Still dominates lineup stretching from cheese to salad dressing, and is afraid to use its muscle to get the best store display.
66 DANONE	4.05	N/A	N/A	France	No. 1 in yogurt outside the U.S. and No. 2 in water, Danone is well-positioned to benefit from health worries.
67 YAHOO!	3.86	4.38	-12	U.S.	Forget the ad slump, Yahoo needs to prove it is relevant to consumers. They become more experienced at browsing.
68 ADIDAS	3.69	3.66	+1	Germany	Benefited from World Cup fever, but still has little appeal among traditionally setting black and Hispanic youth.
69 ROLEX	3.69	3.70	0	Switzerland	There's nothing like a classy watch in bad times. But improved sales are in wait.

Data: Interbrand Corp., J.P. Morgan Chase & Co., *BusinessWeek*

The Global Brand Scoreboard

	2002 BRAND VALUE \$BILLIONS	2001 BRAND VALUE \$BILLIONS	PERCENT CHANGE	COUNTRY OF OWNERSHIP	DESCRIPTION
TIME	3.68	3.72	-1	U.S.	Ads are way off but big news year has helped the magazine's reputation.
ERICSSON	3.59	7.07	-49	Sweden	Ericsson keeps falling further behind Nokia, Samsung, and Motorola.
TIFFANY	3.48	3.48	0	U.S.	With sales down in Japan, the world's most famous jewelry retailer has had to sell more lower-priced gold and silver.
LEVI'S	3.45	3.75	-8	U.S.	Until new designs hit store shelves, Levi's will continue to lose ground to youth-oriented labels.
MOTOROLA	3.42	3.77	-9	U.S.	Suffered from softness in phone handsets and semiconductors, but its greater diversification was a hedge.
DURACELL	3.41	4.14	-18	U.S.	Forced to spend heavily on promotions to hold onto market share, cutting profit margins.
BP	3.39	3.24	+4	Britain	While efforts to recast itself as environmentally conscious are controversial, the BP brand is motoring along.
HERTZ	3.36	3.62	-7	U.S.	Rental car business suffered as more Americans stayed home.
BACARDI	3.34	3.20	+4	Bermuda	Solid marketing and the cachet of its Cuban heritage have the rum brand on a growth track.
CATERPILLAR	3.22	N/A	N/A	U.S.	The No. 1 heavy-equipment brand has steamrolled into merchandise and clothing, playing off its rough-and-tumble image.
AMAZON.COM	3.18	3.13	+1	U.S.	Amazon looks to extend its brand with more retail alliances like the ones it has with Target and Toys 'R' Us.
PANASONIC	3.14	3.50	-10	Japan	It has overhauled product lines and chopped costs, but Panasonic hasn't been able to pull off a Samsung-like makeover.
BOEING	2.97	4.06	-27	U.S.	The grounding of airlines last fall hit Boeing hard. Now it wants to be known as much for its space and defense businesses.
SHELL	2.81	2.84	-1	Brit./Neth.	Ad spending got a boost in 2001, but the brand still has little exposure in the U.S.
SMIRNOFF	2.72	2.59	+5	Britain	Smirnoff got a shot of relevance thanks to the explosive growth of ready-to-drink Smirnoff Ice.
JOHNSON & JOHNSON	2.51	N/A	N/A	U.S.	The strong image of caring built up by its baby products stood the company in good stead.
PRADA	2.49	N/A	N/A	Italy	Fashion exposure was helped by two high-profile store openings but poor market conditions have stalled moves to go public yet again.
MOET & CHANDON	2.45	2.47	-1	France	The champagne brand should pick up fizz after clearing away unsold inventory from Millennium celebrations.
HEINEKEN	2.40	2.27	+6	Netherlands	Its reputation for quality—and high profits—remains intact despite efforts to branch out through acquisitions.
MOBIL	2.36	2.41	-2	U.S.	Tough year for any oil company, but Mobil's strong U.S. focus helped it fare better than most.
BURGER KING	2.16	2.43	-11	U.S.	Diageo's poor supervision of franchisees led to inconsistent quality. Will a new owner do better?
NIVEA	2.06	1.78	+16	Germany	Nivea capitalized on an image of wholesomeness to branch out beyond its core hand and body cream products.
WALL STREET JOURNAL	1.96	2.18	-10	U.S.	Its staid format got a radical re-do, including color reproduction. But the Journal still got smacked by the ad recession.
STARBUCKS	1.96	1.76	+12	U.S.	Starbucks hasn't stumbled yet. There are still gaps to fill in the U.S., as it gears up for expansion in Asia and Europe.
BARBIE	1.94	2.04	-5	U.S.	Another year of brand erosion as little girls opted for more fashionable toys.
POLO RALPH LAUREN	1.93	1.91	+1	U.S.	Modest growth and a U.S. focus helped this brand in a difficult year at the luxury end of the rag trade.
FEDEX	1.92	1.89	+2	U.S.	FedEx consolidated its leadership and secured more flights into Hong Kong to service booming Asian markets.
JOHNNIE WALKER	1.65	1.65	0	Britain	"Keep walking" ad message focusing on personal journeys seemed to strike a chord with younger drinkers.
JACK DANIEL'S	1.58	1.58	0	U.S.	Jack Daniel's "birthday parties" celebrated the brand's 150th year.
3M	1.58	N/A	N/A	U.S.	In a world of commodities, 3M churns out continual innovation to command premium prices.
ARMANI	1.51	1.49	+1	Italy	Twenty new stores slated to open from Milan to Hong Kong this year are helping overcome the downturn.

Data: Interbrand Corp., J.P. Morgan Chase & Co., *BusinessWeek*



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**Making Money
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Why This Bear Is Dancing

Short-seller David Tice has racked up returns of 66% so far this year

BY STEPHANIE
ANDERSON FOREST

You think the bear market is bad now? It's going to get worse, says Dallas money manager David Tice. A lot worse. Tice thinks the Dow Jones industrial average will careen below 3,000 over the next few years. "Because of excesses and imbalances doled out throughout the 1990s, we had a party that wouldn't stop that essentially [was the equivalent of being] on cocaine and tequila," says Tice. "Now we have a big hangover, and we're paying the price for it."

Well, not everyone. For perennial stock market bear Tice, the party may just be getting started. Just look at his Prudent Bear mutual fund. Unlike most fund managers who buy shares of stocks hoping to profit when their prices rise, his \$347 million short fund borrows shares, sells them at a high price, and then buys them back cheap after the prices plummet. So far this year, Prudent Bear has racked up a return of 65.9%, while the Standard & Poor's 500-stock index has plunged 25.6% (chart). In fact, Prudent Bear has had a good run for the past 2½ years, up 107%, vs. a 30% drop in the S&P.

Prudent Bear is one of only a handful of actively managed short funds—that is, Tice mainly picks individual stocks rather than shorting a market index. Tice has made big gains by betting against such onetime Wall Street favorites as Sunbeam, Enron, Tyco, and Amazon.com. "Tice and his associates do their homework," says Alan Papier, a fund analyst at Morningstar. "He's making his shareholders a lot of money in an environment that's really bad for most investors."

Tice insists he doesn't take pleasure in the stock market's misery or in seeing the economy tank. "I'm sincerely saddened by what I see as the prospects ahead," he says. "We are making good money, but we are not cheering for any of this. We'd rather make money with everybody in prosperity." Tice says when the market is good, he adds more long positions. Currently, Prudent Bear is 65% short, 20% long, and 15% in cash.

Tice, 47, has been sounding alarms for more than a decade. After earning an MBA from Texas Christian University in 1977 and doing stints as an internal auditor for an oil company and an analyst for a small investment advisory firm, Tice struck out on his own in Dallas in 1988. His idea was to

do research that most on Wall Street did not. He highlights the potential pitfalls, such as aggressive accounting, of darling stocks. Tice began publishing a scathing twice monthly research report, *Behind the Numbers*, which he sells to institutional investors for \$15,000 a year. The report captures stocks of companies unlikely to fulfill Wall Street's still lofty expectations and that are headed for a fall.

To identify those stocks, Tice and his 15 analysts, five of whom are also accountants, scour a firm's financial reports for earnings quality. This process includes analyzing footnotes, operating earnings momentum, and balance

sheet ratios. In addition, the fund conducts a "grassroots" analysis of companies, which might include discussions with customers, suppliers, competitors, and government agencies. The objective is to stand if investors' hopes are justified. He thinks about reasonable price-earnings ratios for the market.

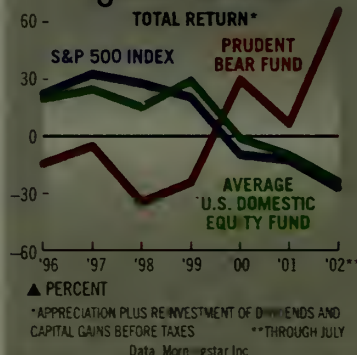
Tice, whose cluttered office is surrounded by three desktop computers, one laptop, and a radio tuned to CNBC to keep abreast of market happenings, attributes his skeptical nature to his accounting background

and his upbringing in Independence, Mo., Harman's hometown. "Missouri is the show-me state, which helps make me somewhat more of a realist," he says.

Over the years, several stocks have suffered the consequences of Tice's dogged scrutiny. They include Warnaco Group, which went bankrupt in June, 2001, seven years after Tice warned of its rising inventories and debt, and Sunbeam Products, which he said in 1996 was taking on huge financial charges that concealed underlying problems. In 1998, Sunbeam restated its financials, and CEO Albert Dunlap resigned.

Tice's most high-profile target was Tyco International. In 1999, his report accused the company of using "accounting intrigue" to boost its earnings, well before the facts about its earnings became known. Shortly after, Tyco's stock fell 40%, and the Securities & Exchange Commission launched a probe but never took action. Days later, given Tyco's rapid fall from grace, Tice could be forgiven for gloating, but he's not ready to declare victory. "The other shoe hasn't really dropped from the accounting perspective," he says.

The Prudent Bear: Against the Trend



Tice's Red Flags

A stock may run into trouble if...

...the balance sheet is growing much faster than the income statement

...receivables and inventories are growing far faster than sales

...the company is reducing discretionary expenditures in order to meet earnings targets

...the company uses pro forma earnings

Data: David W. Tice & Associates



David W. Tice

BORN Sept. 27, 1954, Iowa City, Iowa.

EDUCATION BBA in accounting, Texas Christian University, 1976; MBA in finance, Texas Christian University, 1977.

CURRENT JOB CEO, David W. Tice & Associates (founded in 1988); portfolio manager of the \$347 million Prudent Bear Fund and the \$106 million Prudent Safe Harbor Fund.

PRIOR EXPERIENCE Internal auditor at Atlantic Richfield, 1977-80; corporate development and planning manager, ENSERCH, 1980-84; analyst, Concorde Financial, 1984-87.

INVESTING APPROACH "We look for companies with very high expectations [for future earnings growth] where our independent analysis leads to a different conclusion relative to expectations. . . . We look for aggressive companies that may have taken too much risk, companies where we think the future will be less glowing than what's expected, and companies that are pushing the envelope and using accounting aggressively."

he says. "The stock has had two legs down their debt problems and to [CEO Dennis] Waski's personal stuff." That's why Tice is shorting Tyco in the Prudent Bear fund.

Tice started Prudent Bear in December, 1995, giving investors a place to make money in a market. His timing was lousy. In each of the fund's first four years, the market posted gains, and he racked up losses. "We went through some tough times in the early days," Patrick Ohnmeis, a retired American Airlines pilot who has been a Prudent Bear investor since 1997. "But I stuck by him because I believed, like he did, that the market was an inflated bubble. Now, we're making lots and money."

Like those years were painful, Tice says he has considered throwing in the towel because the case was based on solid analytical research of individual companies, the stock market, and economic history. "We knew we were going right, it was just a matter of when," he says. "A lot of bears, because they didn't possess conviction, because they didn't have the an-

alytical support for their argument, thought: 'What's going on? We must be wrong.' Well, I'm an independent thinker...and the three legs of our stool gave me the confidence we were right."

These days, Tice is betting he's right about the 150 stocks, including General Electric and Dynegy, that he admits to shorting in the Prudent Bear fund. Tice is also betting against stocks in telecom, semiconductors, and financial services, particularly subprime and credit-card lenders. He declines to be more specific. Among the largest short positions mentioned in the most recent shareholder report, dated Mar. 31, are U.S. Cellular; Electronic Arts, the video-game software company; and Pixelworks, which makes graphics chips and software.

So, what does Tice like? Gold stocks, in which he has long positions, and two-year Treasury bonds. Beyond that, his advice for investors? "They should be like a squirrel in terms of storing their nuts and take care of their finances," he says. "They ought to think about selling their stock." Or consider short selling—either themselves or with a manager like David Tice. ■

Despite Tyco's fall from grace, Tice is still shorting the stock. "The other shoe hasn't really dropped from the accounting perspective yet," he says

The Art Of Selling Short

Feel brave? Here's how to make friends with the bear

BY LEWIS BRAHAM

Be careful of this strategy because in theory your potential losses are unlimited. That's why the pros use various tactics to limit their risk

It may appear unseemly to profit from others' misfortunes, but hey—it's a bear market. That's why the strategy known as short-selling is so hot. The greater a stock's decline, the bigger the profit for the short seller. While shorting can be fraught with risk, if done correctly, it can be a useful tool for enhancing or protecting your portfolio.

Here's how it's done. When you ask to sell short, your broker borrows shares for you and sells them (table). The proceeds are deposited in your account. Say you short the stock at \$20 and then it drops to \$15. You may then buy the shares you sold back at that price—that's "covering your short"—and return them to your broker to repay your loan. Your profit is the \$5 difference between the sell price and the buy.

But in practice, shorting is rarely so simple. Suppose the stock you shorted at \$20 heads north to \$30 or \$40 or \$60. The more it rises, the more money it will cost to buy back the shares you owe. And consider this: When you buy a stock, the worse case is you lose everything. With short-selling, potential losses are unlimited as stock prices have no ceiling. "You have limited gains and unlimited liability," says Chuck Zender, portfolio manager of the Grizzly Short Fund. "So you must have some method of limiting your risk."

That's why the pros follow strict disciplines. Zender starts covering if a stock rises more than 25% from the price he sold short. Also, if the stock starts rising much faster than the market or its historical pattern, he's out.

Liquidity is also crucial. Many pros avoid very small companies with low trading volume. Why? If you're wrong and the shares start to rise, you may get caught in a "short-squeeze." That's when

increased demand for shares pushes the stock's price up even higher, amplifying losses. Zender does not short stocks with capitalizations of less than \$1 billion or a daily trading volumes that are less than 6 shares.

You should also look at a stat known as "short interest," which measures the total amount of shares sold short on a stock. If the short interest is high, a rise in the stock could also cause a short squeeze. Ted Kellogg, portfolio manager of the Boston Partners Long/Short Equity Fund, compares the short interest with the daily trading volume of the stock to see if enough shares trade daily to cover a sudden short-squeeze demand. If the short interest is more than 10 times the average volume, he steers clear.

Margin is another consideration. Most brokers require you to have at least 50% of the value of the borrowed shares in cash in your account to

establish a short position. And when they'll set a margin maintenance requirement, upwards of 25% of the borrowed stock's value, to maintain the position. If the stock rises, the amount of cash borrowed also increases, and you may experience a margin call, which means you have to add more cash to the account or the broker will close out your position. Zender recommends putting up 100% of the value to insulate yourself from calls.

Not every short position has to be exceptionally risky. Instead of making a speculative bet on a stock falling, you could short to hedge existing holdings. This can be useful for conservative investors. For instance, you're worried about shares of a stock you bought at \$10 that trade for \$100. Instead of selling your shares and realizing a large capital gain, you set up a short position in the same stock to offset against declines. When the danger has passed, you can cover your position.

But otherwise, shorting is not for the faint of heart. "Shorting is not something to do unless you have a high degree of certainty a company's fundamentals are poor and it can spend a lot of time waiting for its stock," says Kellogg. While many short sellers are sitting pretty now, remember that over the long term, markets usually go up.



Shorting: A Primer

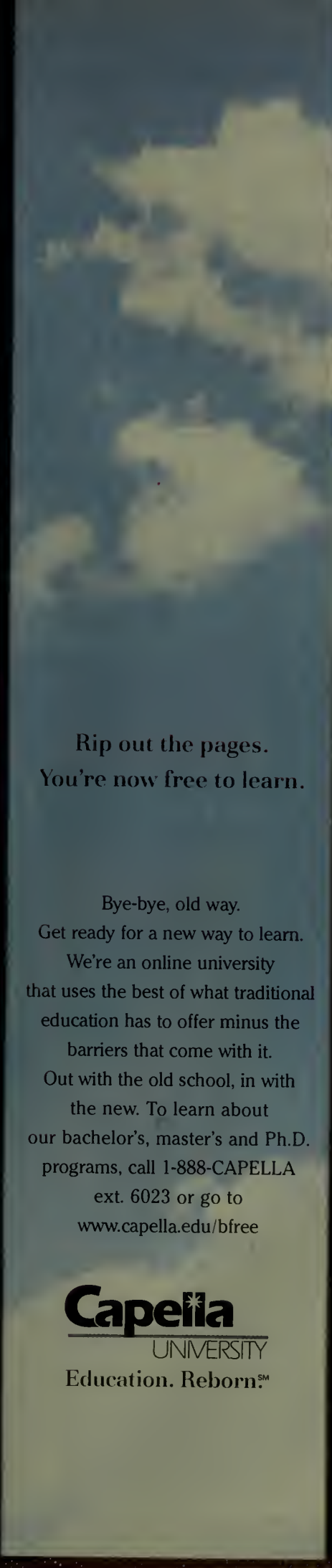
► You borrow 500 shares of a company whose stock you expect to fall and sell them at \$20 a share.

► The sale proceeds of \$10,000 go into a margin account, along with an initial margin payment of 50% of the borrowed amount—\$5,000.

► If the stock drops to \$15 a share, you buy back the 500 shares, making a profit of \$2,500—the difference between the \$10,000 initial sale and the cost of replacing the borrowed stock. You also gain access to the \$5,000 margin you put up.

► If the stock rises to \$25 a share and you cover at that price, you lose \$2,500. If you hold the position and the stock continues to rise, you will be required to put up cash or equivalents amounting to at least 25% of the stock's value.

Examples do not include brokerage and interest costs



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A Rocky Market's Steady Performers

How these funds are playing defense

BY LEWIS BRAHAM

Not that long ago, investors complained that their mutual funds didn't deliver digit returns—every month. Now they feel lucky if their funds don't fall every day. With the average domestic equity fund down 23% this year, the primary concern for investors is making a little money while taking huge downside risk.

BusinessWeek's Mutual Fund Scoreboard can help in this department. This fund tool, updated monthly and available at www.businessweek.com/funds, ranks funds on their five-year total return, adjusted for downside risk and rates them from F to A. So funds that have high returns, but are subject to volatile downswings, often won't do as well as those that have lower returns but offer a much smoother ride. Only the top 10% of the more than 3,400 equity funds and 1,600 bond funds the scoreboard rates receive A grades.

Since our last ratings review (BW—Jan. 2001), the A-list has seen a number of significant changes. Of the 160 A-rated equity funds, 60 are new (table). Of those, 42 are small- and mid-cap funds. Many large-cap stalwarts, such as Growth Fund of America, Janus Growth & Income, and Dividend Growth, have fallen off. That should be no surprise given the bludgeoning of the technology, telecom, and even pharmaceutical stocks this year.

Large-cap growth funds are doing poorly relative to all funds, but there's a way to see how any fund is performing relative to its peers. That's the category rating, in which the comparison is just among like funds. So a fund that is no longer merits an A rating overall can be top-rated within its fund category.

What's most interesting is a fund that has an overall A rating even though it invests in an out-of-favor sector. Two such funds, Julius & Edgar International Equity and Artisan International, made it to the top even though overseas markets trailed the U.S. for most of the last five years. Both got As in category ratings, too.

How do they do it? Baer portfolio manager Richard Pell says he reduces risk through diversification—the fund typically has at least 10 holdings in 25 countries—but also by applying different strategies for different countries. In developed European nations, he analyzes a company's business model first and considers the country's economic condition second. In emerging markets such as Brazil and Taiwan, he uses a reverse approach because stocks there are more strongly tied to economic factors. "If we don't like an emerging country, we won't buy a stock there, no matter how cheap it is," he says. This has kept him out of Latin America since Argentina's economic crisis began, while other large-cap managers have suffered big losses there.

Some large-cap managers have retained their A grades by playing defense. PBHG Large Cap Fund kept its grade by investing in prime companies with strong, clean balance sheets. Manager Raymond McCaffrey has also been bulking up on Baby Bell stocks such as Verizon.

ications, SBC Communications, and Bell-
which pay relatively high dividends. "Un-
ings, dividends can't be manipulated by
nts," he says. The dividend also acts as
n against stock slides. McCaffrey's fund
n a hit this year from bets in the phar-
al sector, but his overall record is sound.
s that are not tethered to a specific sec-
e market can use that flexibility to tem-
k. John Thompson runs the A-rated
on Plumb Growth, which is an all-cap
at can invest in companies of any size.
ars ago he was 50% invested in small-
s they were much cheaper than large.
lped buoy him during the blue-chip bear
but now he has shifted 70% of his assets
-cap stocks. "When small-caps are valued
e as large, we migrate to large," he says.
hips are more seasoned companies with
arriers to entry for competition."

ie small-cap sector, the funds that buy
with market caps less than \$300 million
ing. "These stocks fly beneath the radar
of institutional investment firms and bro-
analysts," says Bruce Baughman, portfo-

lio manager of Franklin MicroCap Value Fund,
up 5% this year. He controls risk with a classic
value strategy: Buy stocks so cheap there's little
room for them to fall. Says Baughman: "When
you buy a dollar's worth of assets for 80¢, you
have an extra margin of safety."

The stocks small-cap growth funds buy never
look cheap at the time of purchase. They're only
cheap in hindsight if the stock pays off big. So
how do those funds limit risk? They make sure a
stock with high earnings expectations priced into
its shares can meet them. "There are businesses
reporting profits right now, which after you ad-
just for the cost of stock options, are at a loss or
significantly more expensive than they would
appear on the surface," says Transamerica Pre-
mier Growth Opportunities portfolio manager
Kenneth Broad. Although his fund has been hurt
by the sell-off, it has outperformed its peers.

There are even three A-rated tech funds—
Icon Information Technology, Kinetics Internet,
and Waddell & Reed Adviser Science & Tech-
nology. All are down sharply this year, but if
the sector rebounds, don't be surprised if these
three lead the charge.

**In the small-cap
sector, funds that
focus on stocks
with market caps
of less than
\$300 million
are shining**

BusinessWeek online

For fund ratings and more,
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A-Rated Funds

How much risk did a mutual fund take to earn that return? *BusinessWeek* looks at risk and return over a five-year period. Funds are given a rating (A through F), and these ratings are updated monthly at BusinessWeek Online. The following equity funds joined the A-list in the most recent review.

	CATEGORY	AVERAGE ANNUAL TOTAL RETURN*	FUND	CATEGORY	AVERAGE ANNUAL TOTAL RETURN*
D CAP EQUITY A	Mid-cap Blend	12.2%	LIBERTY SELECT VALUE A	Mid-cap Value	11.9
ALL CAP GROWTH A	Small-cap Growth	14.1	LONGLEAF PARTNERS SMALL CAP	Small-cap Value	10.2
N INTERNATIONAL	Foreign	11.1	MERRILL LYNCH GLOBAL SMALL CAP B	World	11.0
N MIO CAP	Mid-cap Growth	23.3	MOSAIC EQUITY TR. MIO CAP	Mid-cap Value	10.8
N SHAOOW STOCK	Small-cap Value	11.9	MS FINANCIAL SERVICES TR. B	Financial	12.5
GROWTH	Small-cap Growth	12.1	MS HEALTH SCIENCES B	Health	11.2
SMALL CAP VALUE INV.	Small-cap Value	16.1	MS INSTL. SMALL COMPANY GROWTH B	Small-cap Growth	14.8
AN MICRO CAP GROWTH	Small-cap Growth	29.3	MUNDER SMALL CAP VALUE Y	Small-cap Value	10.9
MILTON SM. CAP. GR. INV.	Small-cap Growth	11.7	NI NUMERIC INVESTORS MICRO CAP	Small-cap Growth	12.5
	Domestic Hybrid	10.3	ONE GROUP MIO CAP VALUE I	Mid-cap Value	12.0
GO EQUITY Y	Mid-cap Growth	14.3	ONE GROUP SMALL CAP VALUE I	Small-cap Value	11.0
LO SELECT BANKING & FINANCE A	Financial	11.4	PBHG MIO CAP VALUE	Mid-cap Value	18.8
NANCIAL SERVICES A	Financial	10.8	PBHG SMALL CAP VALUE	Small-cap Value	12.6
ALL CAP VALUE A	Small-cap Value	11.8	PIMCO VALUE C	Mid-cap Value	10.4
TEO MIO CAP INDEX	Mid-cap Blend	11.7	PIONEER SMALL CAP VALUE A	Small-cap Blend	12.5
ORE EQUITY INCOME	Mid-cap Value	10.4	QUAKER AGGRESSIVE GROWTH A	All Cap	21.6
TY NEW MILLENNIUM	Small-cap Growth	14.5	RESERVE PRIVATE EQ. SMALL CAP GR. R	Small-cap Growth	13.0
TY SEL. CONSTRUCTION & HOUSING	Miscellaneous	11.6	ROYCE MICRO CAP INV.	Small-cap Value	13.2
TY SEL. OFFENSE & AEROSPACE	Miscellaneous	11.7	SANTA BARBARA BENDER GROWTH Y	Small-cap Growth	14.1
MMON STOCK	Mid-cap Value	10.4	SECURITY CAPITAL U.S. REAL ESTATE	Real Estate	10.7
LIN MICROCAP VALUE	Small-cap Value	13.1	SECURITY MID CAP VALUE A	Mid-cap Value	18.8
LI SMALL CAP GROWTH AAA	Small-cap Value	9.8	STATE ST. RES. MIO CAP VALUE A	Mid-cap Value	11.3
LAND VALUE	Small-cap Value	10.3	STRATTON MONTHLY DIVIDEND REIT	Real Estate	9.4
KIS & WILEY MIO-CAP VALUE I	Mid-cap Value	15.0	T. ROWE PRICE SMALL CAP VALUE	Small-cap Value	10.4
HEALTHCARE	Health	12.0	TOCQUEVILLE SMALL CAP VALUE	Small-cap Value	14.0
INFORMATION TECHNOLOGY	Technology	16.3	TRANSAMERICA PREMIER GRWTH. OPP. INV.	Small-cap Growth	19.1
LEISURE AND CONSUMER	Miscellaneous	13.9	VALUE LINE EMERGING OPPORTUNITIES	Small-cap Growth	14.5
ADVISER CAPITAL APPRECIATION	Large-cap Growth	11.5	VALUE LINE SPECIAL SITUATIONS	Small-cap Growth	12.8
S BAER INTERNATIONAL EQUITY A	Foreign	11.6	VONTOBEL U.S. VALUE	Large-cap Value	10.5
Y SMALL CAP VALUE	Small-cap Value	12.5	WASATCH ULTRA GROWTH	Small-cap Growth	12.3

*Data through June 30. Appreciation plus reinvestment of dividends and capital gains before taxes

Data: Standard & Poor's



The Beauty of Inflation-Proof Bonds

Beyond protection, TIPS offer solid returns

BY SUSAN
SCHERREIK

Investors yawned when Washington began selling inflation-indexed bonds in early 1997, a time when the stock market was going gangbusters and inflation was near historic lows. They have since picked up on the merits of Treasury Inflation-Indexed Securities, widely known as TIPS. A just-released report by Bridgewater Associates, a Westport (Conn.)-based investment management firm, shows TIPS gained 9.61% this year through July 22, one of the best-performing investments so far in 2002.

Demand has been so strong that the Treasury auctioned off \$9 billion of 10-year TIPS on July 10, the largest sale of these securities ever. A day earlier, Fidelity Investments opened the ninth TIPS mutual fund launched since 1997. Assets in these funds, which include offerings by American Century; Brown Brothers Harriman; Pacific Investment Management; and the Vanguard Group, have increased 74% since January, to \$7.4 billion at the end of June, according to Lipper.

As with an ordinary bond, TIPS pay a coupon, or interest rate. But the principal value is adjusted twice a year to reflect inflation, as measured by increases in the consumer price index. Say you pay \$1,000 for a TIPS bond that carries a 3% coupon. If inflation was 1% during the first six months of the year, the principal would be increased to \$1,010. Instead of receiving a semi-annual interest payment of \$15 (half the 3% times \$1,000), the payment would be \$15.15.

The eye-opener for many investors is that

TIPS have proven to be relatively strong performers when inflation is mild, as is the day. "People mistakenly thought they needed inflation-indexed bonds if there was no 1970s-type [double-digit] inflation," says Bernstein, director of research at Bridgewater Associates. "For TIPS to do well, inflation needs only to come in slightly higher than the market anticipates."

To figure out when TIPS are attractive, compare the yield from that of a traditional Treasury security of the same maturity. In January, for instance, 10-year TIPS yielded 3.53%, vs. 5.5% on a 10-year Treasury note, resulting in a "break-even" inflation rate of 1.76%. That meant inflation would need to rise above 1.76% over the next decade for TIPS to outperform Treasury.

Since January, however, the CPI has disappointed expectations and risen from an annualized 1.6% to 3%, causing TIPS prices to rise substantially. Today, the break-even inflation rate between 10-year TIPS and Treasury notes is 1.6%. Although TIPS are no longer cheap, Bernstein believes they remain a good deal because he sees the inflation rate staying at today's levels over the next few years.

Financial advisers steer investors away from buying TIPS simply to bet on inflation expectations. "The purpose of TIPS is not to try to make a killing but to preserve your real purchasing power over time," says Harold Evensky, a financial planner in Coral Gables, Fla. Evensky urges his clients to keep as much as half of their fixed-income portfolio in TIPS funds, with one caveat: They belong only in tax-deferred accounts. That's because you must pay tax each year on any principal increases although you don't pocket the money until the bond matures. The law requires TIPS funds, however, to pass on that inflation-related income to investors each year.

Simply because they provide protection against inflation, TIPS belong in your portfolio. But their sterling credit quality and relatively robust returns make them even more attractive. ■

How to Buy TIPS

U.S. TREASURY

Auctions in January, July, and October sell 10-year TIPS as little as \$1,000. No commissions. Open account at www.treasurydirect.gov

BROKERAGE FIRMS

Sell TIPS of various maturities, from 1 to 29 years.

MUTUAL FUNDS

American Century Inflation-Adjusted Bond (ACITX), 800 345-2021

BBH Inflation-Indexed Securities N (BBINX), 800 625-5759

Fidelity Inflation Protected Bond (FINPX), 800 544-4444

PIMCO Real Return Bond A (PRTNX), 888 877-4626

Vanguard Inflation Protected Securities (VIPSX), 800 662-7447

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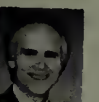
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WILL THE SEC BLESS THIS MASQUERADE?



BY ROBERT BARKER

rb@businessweek.com

A proposed rule change would allow stockbrokers to advise like a planner without disclosing conflicts, as planners are required to do

No one needs another corporate outrage. But you need not even have money in the market to be grievously offended by a pending change in the rules governing Wall Street. All you need is a minimal respect for truth in advertising.

I'm talking about a proposed revision in the Securities & Exchange Commission's rules defining the differences between a stockbroker and an investment adviser. The formal title of this proposal is "Certain Broker-Dealers Deemed Not To Be Investment Advisers." After nearly three years, it remains on the SEC's back burner as regulators struggle to keep up with everything else that's boiling over. But from all signs, the SEC still plans to move ahead with the new rule.

The logic for this change traces the shape of a pretzel, so please follow closely. Under a 1940 law, anyone who both offers investment advice and charges an asset-based or flat fee has been required to register as an investment adviser. The point was to distinguish advisers from stockbrokers. Advisers, the law holds, must act as fiduciaries—putting clients' best interests before their own and disclosing any conflicts of interest. As fiduciaries, investment advisers are expected to be on the client's side of the negotiating table in any deal.

Brokers, of course, have their own burdens under other rules, among them to offer customers only suitable investments and to treat them fairly. But Congress saw brokers as essentially different. Instead of acting as fiduciaries, they are agents of the firms they work for. They may offer the odd stock tip or some occasional advice, but regulators viewed that as incidental to a broker's main business of accumulating trades and commissions. A broker's first duty is to the firm, not the customer.

But as the bad behavior among too many brokers accumulated over the years and imperiled the term "stockbroker," new marketing guises cropped up. Here's how Merrill Lynch describes its "Unlimited Advantage" brokerage account on its Web site: "Gain the advantages of an as-

set-based fee structure.... Consult with a Financial Advisor to target your investment, identify your investor profile, and develop an asset-allocation strategy. Your Financial Advisor will work with you to create a financial plan. So Merrill's "Financial Advisor" sounds more than a broker. A spokesman said the title "Financial Advisor" because the SEC requires us to, and we believe it accurately describes the full panoply of services that we offer.

The trouble is, since 1999, when Merrill introduced Unlimited Advantage, offering advice, and asset-based fees, the rule has forced the firm to register its brokerage investment advisers. The same would be true for the other firms, such as Morgan Stanley, J.P. Morgan Smith Barney, that also now offer investment services from a brokerage account for a flat fee.

Why would brokers not want to register as investment advisers? Because they would

operate differently—as

advisers, not agents—and

provide much crucial information.

Brokers can

use securities to

draw from a firm's

inventory of

securities, revealing

trade mis-

conduct that

benefit the

broker's se-

curities, not

customer's

firm's own

portfolio, for ex-

ample, or she need

the customer

much its pr-

marked up. An

investment adviser would

spell that out.

Wall Street found sympathy in Washington. The SEC has been pressuring brokers to offer asset-based fees as a way to discourage "churning," or unwarranted trading, by unsupervised brokers bent on keeping their commissions. When Wall Street's plea to escape the SEC's rule for investment advisers met Washington's demand for more asset-based fees, the proposal was conceived. Even as it's pending, many brokers are being exempted from having to register as investment advisers.

When the SEC finally acts on the proposal, the chances are it will insist that Wall Street's marketing materials make much plainer than that a brokerage account, whether fee-based or commission-based, is no more than that and not an advisory service. Yet given the Street's notorious behavior and Washington's inept oversight, I hold no hope that most individual investors will see through this masquerade.



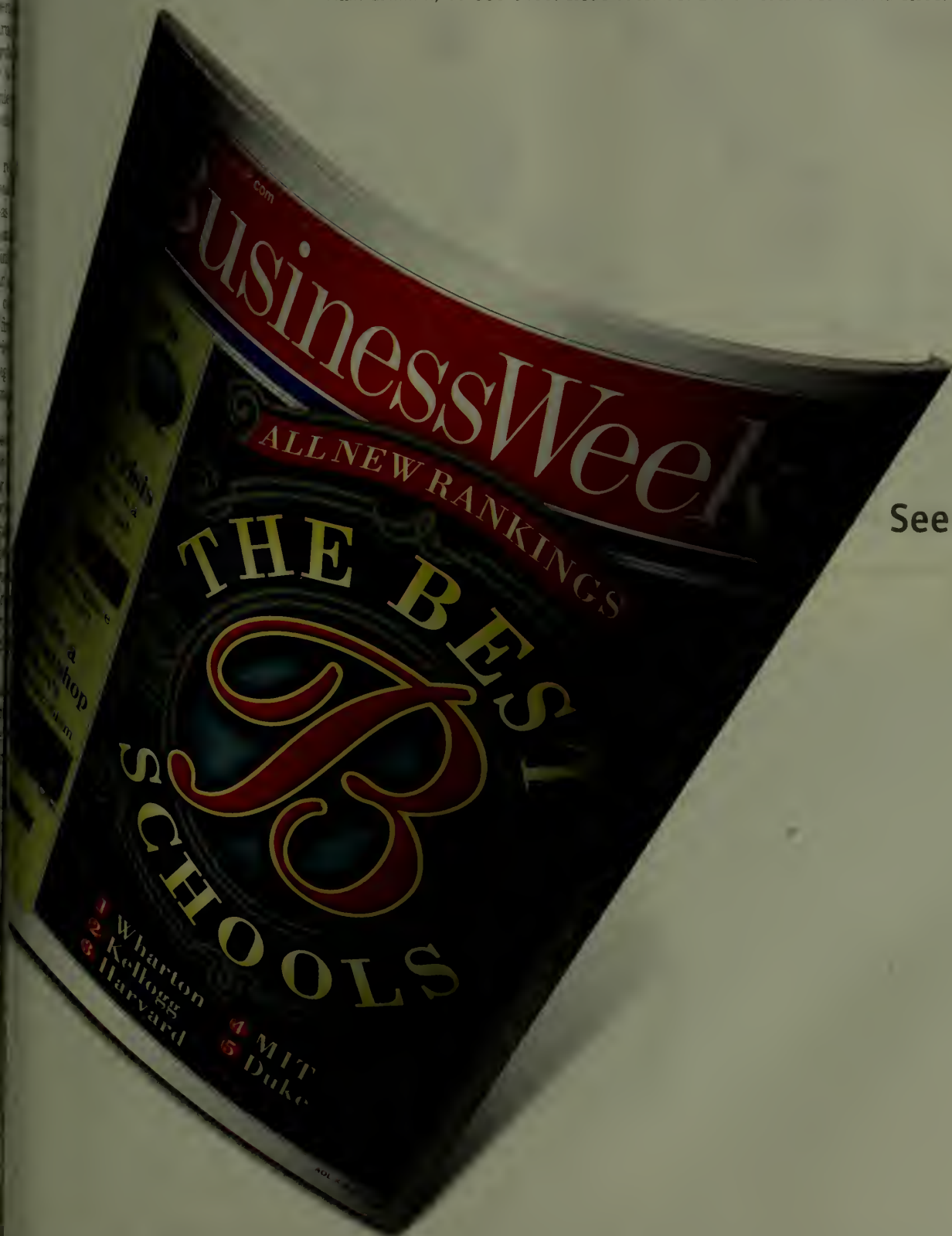
BusinessWeek online

For barker.online, go to www.businessweek.com/investor/ and click on "C

The A-list of B-schools.

Required reading for the current generation of business leaders and the next. To reach them, contact Geoff Dodge at 212-512-4611; London—Paul Maraviglia, 44-20-7330-9051; Singapore—

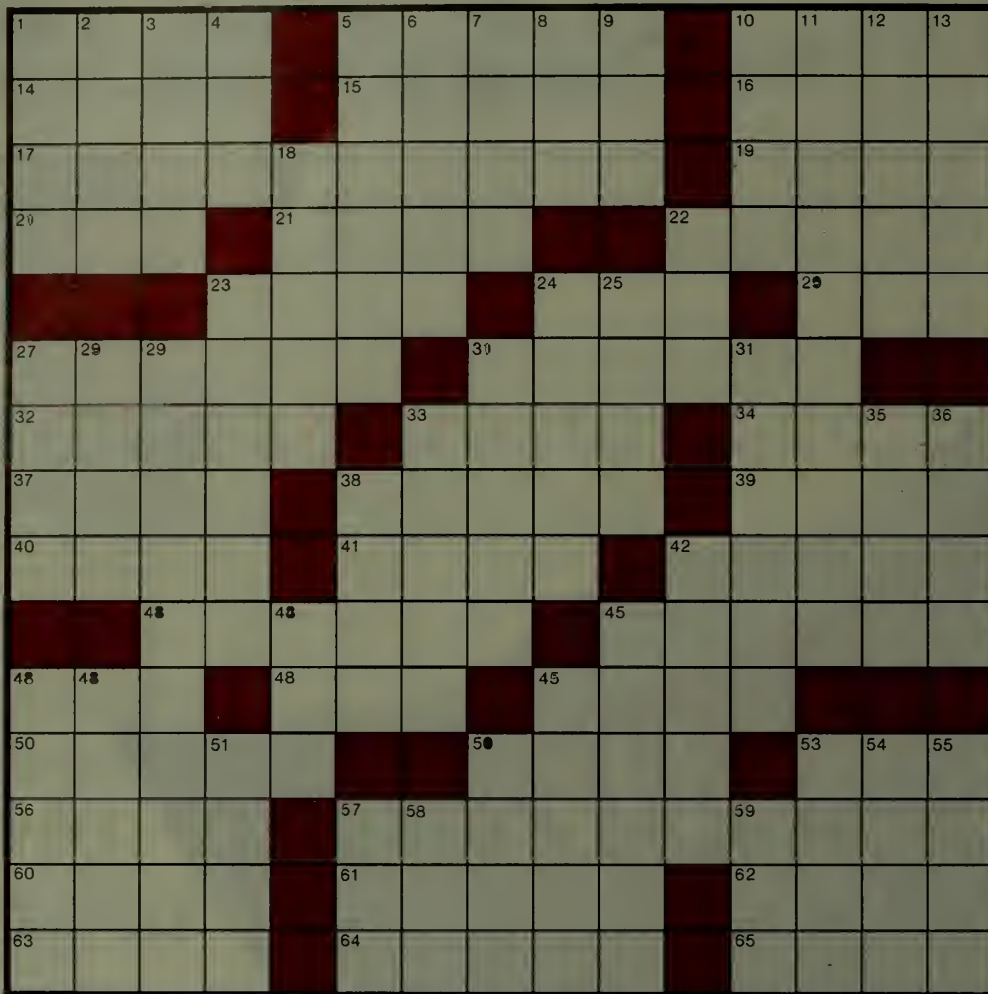
Alan Lammin, 65-530-6400. Issue date: Oct 21. On sale: Oct 11. Ad close: Sep 23.



See inside

- MAGAZINE
- ONLINE
- TELEVISION
- EVENTS

Mixing Business with Pleasure by Lincoln



ACROSS

1. Economist Smith
5. Annoyed
10. Food for hogs
14. State with a U.S. Mint: Abbr.
15. Suit material
16. Fiscal period
17. Regulatory agency
19. Brussels-based alliance
20. __ la la
21. Regrets
22. DHL competitor
23. MGM founder
24. Bullfight cheer
26. Suffix for trick or crock
27. Not exactly deluxe
30. It bought Warner-Lambert in 2000
32. Impressive grouping
33. Sciences' partner
34. "This __ sudden!"
37. Six, in Spain
38. "Glengarry Glen Ross" playwright
39. Former CNN anchor
40. Carryall
41. OPEC member
42. Table-setting piece
43. Word in many utility names
45. Techie's clip-on
46. Postal Service abbreviation
48. "Smoking" alternative
49. Equitable
50. Float __ (one way to raise funds)
52. Emporium
53. Viacom network
56. Auto Club offerings
57. Benefits Department concern
60. "Chivalry __ dead..." (see page at right)
61. Telegraph inventor
62. Powerful word in mail order
63. __ buco
64. Katharine Graham's maiden name
65. Probability quotation

DOWN

1. Ad-agency client: Abbr.
2. Navigator running board deploy when this is open (see page at right)
3. __ mater
4. Family member
5. Put into circulation
6. Fix a garment
7. Mr. Kringle
8. Conceit
9. Family room
10. "Auld Lang __"
11. Executive attribute
12. Western film, so to speak
13. Authorized representative
18. Literary device
22. Shriner's topper
23. Like much office equipment
24. All the time
25. Agenda, essentially
27. Wear well
28. Billion-selling cookie
29. Banes for 59 Down
30. Promotion person
31. "Work in Progress" autobiographer
33. TV producer Spelling
35. Riskless
36. One in debt
38. Japanese soup flavoring
42. Rupert Murdoch's real first name
44. B&B
45. Cashless transaction
46. P/E, e.g.
47. Dentist's advice
49. Not so
51. Concerning
52. Mrs. James Carville
53. King or queen
54. Born and __
55. Gets the point of
57. "Let me see..."
58. Fairness-in-hiring: Abbr.
59. High-level exec

For answers to this puzzle:

Turn to page 119 in this week's issue of BusinessWeek or visit Mixing Business with Pleasure by Lincoln on www.businessweek.com/adsections

Puzzle created by: Stanley Newman.



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The background of the advertisement is a photograph of a woman in a patterned dress, captured in a dynamic, almost dancing pose. She is positioned in front of the open rear door of a Lincoln Navigator. The Lincoln logo, a vertical oval with a shield inside, is centered above the word "LINCOLN" in a serif font.

LINCOLN

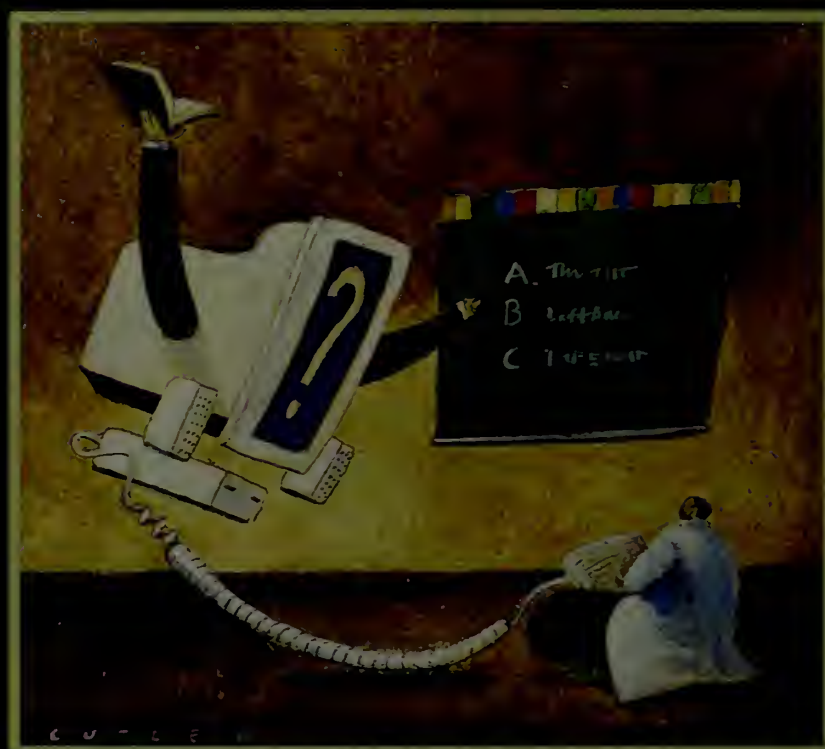
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5. Liberty University
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BusinessWeek

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*2002 Spring MRI; BusinessWeek estimate for International.

MORE TEARS AT J&J



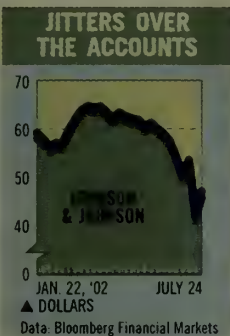
Gene G. Marcial

steep drop
are chance to
up the stock.
survivor
is sitting
for suitors.
ability fears
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In these days of volatile markets—when investors sell fast and ask questions later—any company might see its stock crater within hours. But such cases can also open up buying opportunities. That's what happened at Johnson & Johnson (JNJ), the world's largest health-care company, on July 19, when a blizzard of instant selling whacked its stock down 16%, to 41.85—a 52-week low. It has since rebounded to 47. Investors got jittery when J&J revealed that the Food & Drug Administration was looking into a fired employee's allegation of record-keeping irregularities—which J&J denies—in Puerto Rico. This plant makes Eprex, an anemia drug sold outside the U.S. that recently attracted scrutiny after being linked to 141 cases of pure red-cell aplasia, a life-threatening anemia. J&J officials say the anemia was most likely caused by the way the drug was injected—under the skin rather than into a vein, as J&J recommends. J&J points out that the anemia has cropped up in only 1.14 patients out of 10,000.

Pros who know J&J well jumped at the stock's drop. "Historically, any chance to buy J&J at such a low multiple—16 times estimated 2003 earnings of \$2.62 a share—has been a golden opportunity," says Lew Rabinowitz of New York hedge fund R. Lewis Securities, which bought shares on July 22. He sees J&J earning \$2.25 a share in 2002 and the stock rebounding to its old high of 65 in 12 months—close to consensus estimates. Robert Dunne of Dresdner Kleinwort Wasserstein, who rates J&J a buy and owns shares, doubts the FDA will uncover criminal activity. The plant, he notes, was inspected recently by the FDA and French regulators. Glenn Novarro of Credit Suisse First Boston, who does not own shares, says: "We would be aggressive buyers" at these price levels.

IN TRUTH, VERITY 'IS LOOKING STRONG'



growth from 1999 through the fiscal year ended May 31, 2001, as sales climbed from \$64.4 million to \$145 million and earnings grew from 44¢ to 92¢ a share. But as capital spending dried up, business faltered: In fiscal 2002, sales slid to \$93 million, and earnings to 8¢. Nevertheless, earnings in the third and fourth quarters of fiscal 2002 showed strength and beat estimates. And the first fiscal quarter of 2003 "is looking strong," says Cohen, who sees the stock doubling in a year. "With its cash and clean balance sheet, Verity is a possible takeover target by large enterprise-software companies, as the industry consolidates," he says. It's very well-positioned, he adds, against rivals Inktomi and Autonomy. First Call figures Verity will earn 33¢ a share in fiscal 2003 and 47¢ in 2004. On July 22, the Defense Dept. announced it had integrated Verity software into its new message-handling platform, involving more than 40 sites.

FALSE ALARM AT MANOR CARE

Elliot Schlang, of Cleveland investment firm Lynch, Jones & Ryan, has turned even more bullish on nursing home chain Manor Care (HCR) as its stock weakened—from 26 in early May to 19. He thinks Manor, the largest for-profit U.S. provider of long-term care, skilled nursing, and rehabilitative services, has become more enticing at its low price: "With the market's current mistrust of large-cap companies because of Enron and WorldCom, Manor becomes a solid shelter," says Schlang, who owns shares. He thinks investors seeking companies with clean balance sheets and profitable operations in niche markets will find Manor attractive. Part of its recent dip—from 20 to 18 on July 19—was due to a report by rival Beverly Enterprises, the largest U.S. operator of nursing homes and assisted-living centers, that it expected to take a big charge in the second quarter to cover liability claims in the prior year. Analysts such as Albert Rice of Merrill Lynch, however, say Beverly's situation has no direct bearing on Manor. In fact, he notes liability-insurance costs at Manor moved in a favorable direction in the first quarter. The costs were down from last year's, and the average claim dropped, says Rice, who owns shares. At 19, the stock is selling at 13.5 times Schlang's 2002 earnings estimate of \$1.40 a share and 11.7 times his 2003 \$1.62 forecast. His 12-month price target: 35.



Verity (VRTY) is one of the few techs to go public during the 1990s and survive—with earnings to boot. This provider of software for corporate intranets and e-commerce sites "has a very strong balance sheet, with no debt and net cash of \$6.50 a share," says Jonathan Cohen of JHC Capital Management in Greenwich, Conn., who owns shares. Verity, which went public in 1995 at 6 a share and now trades at 10.66, posted strong earnings and revenue

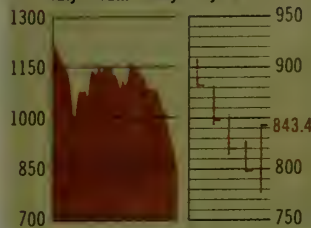
BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:50 p.m. EST on CNNfn's *The Money Gang*.

Stocks

S&P 500

July Jan. July July 18-24



COMMENTARY

Shazam! The markets were a marvel as investors marched back into stocks on July 24, staging a rally that snapped a four-day losing streak. The Dow Jones Industrial average's 489-point rise was its largest one-day gain in 15 years. The S&P 500, which had just touched its lowest level since 1995, surged 5.7%. Still, the Dow, the S&P 500, and Nasdaq, ended the week in the red.

Data: Bloomberg Financial Markets
Reuters

U.S. MARKETS

	July 24	Week	% change Year to date	Last 12 months
S&P 500	843.43	-6.9	-26.5	-28.0
Dow Jones Industrials	8,191.3	-4.1	-18.3	-20.0
Nasdaq Composite	1290.2	-7.7	-33.8	-34.1
S&P MidCap 400	414.1	-6.7	-18.5	-16.3
S&P SmallCap 600	190.2	-6.4	-18.1	-14.3
Wilshire 5000	8,009.2	-6.8	-25.2	-26.2

SECTORS

	July 24	Week	% change Year to date	Last 12 months
BusinessWeek 50*	511.9	-5.8	-29.9	-35.2
BusinessWeek Info Tech 100**	272.6	-7.7	-35.0	-34.9
S&P/BARRA Growth	434.3	-5.0	-27.0	-26.3
S&P/BARRA Value	406.2	-9.0	-26.4	-30.3
S&P Energy	176.6	-7.0	-16.4	-18.6
S&P Financials	278.5	-8.9	-21.6	-24.3
S&P REIT	86.0	-8.2	-7.9	-7.0
S&P Transportation	164.2	-9.6	-16.7	-17.2
S&P Utilities	93.3	-10.5	-36.0	-44.6
GSIT Internet	63.7	-9.2	-39.3	-42.4
PSE Technology	444.2	-7.8	-35.4	-31.4

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

BEST-PERFORMING GROUPS

	Last month %		Last 12 months %
Computer Stge. & Perphs.	1.9	Metal & Glass Containers	30.9
Photographic Products	-3.3	Housewares & Specialties	24.3
Semiconductors	-4.2	Managed Health-Care	24.0
Food Chains	-4.5	Casinos	19.2
Wireless Services	-5.0	Homebuilding	13.4

GLOBAL MARKETS

	July 24	Week
S&P Euro Plus (U.S. Dollar)	815.6	-13.5
London (FT-SE 100)	3777.1	-9.9
Paris (CAC 40)	3023.7	-12.1
Frankfurt (DAX)	3632.7	-11.2
Tokyo (NIKKEI 225)	9947.7	-3.4
Hong Kong (Hang Seng)	9972.0	-3.5
Toronto (TSE 300)	6382.1	-4.7
Mexico City (IPC)	6010.4	-6.1

FUNDAMENTALS

	July 23
S&P 500 Dividend Yield	1.94%
S&P 500 P/E Ratio (Trailing 12 mos.)	28.5
S&P 500 P/E Ratio (Next 12 mos.)*	14.1
First Call Earnings Surprise*	0.83%

*First Call Corp.

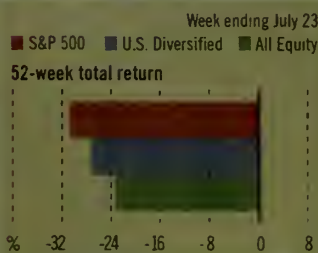
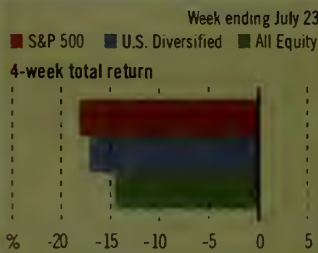
TECHNICAL INDICATORS

	July 23	Week
S&P 500 200-day average	1091.0	10
Stocks above 200-day average	19.0%	
Options: Put/call ratio	0.93	
Insiders: Vickers NYSE Sell/buy ratio	3.17	

WORST-PERFORMING GROUPS

	Last month %		Last 12 months %
Multi-Utilities	-42.1	Multi-Utilities	
Office Electronics	-37.6	Wireless Services	
Oil & Gas Drilling	-28.9	Telecomms. Eq.	
IT Consulting	-28.3	Movies & Enter.	
Broadcasting	-28.2	Airlines	

Mutual Funds



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-week total return	%	52-week total return	%
Leaders			
Japan	0.0	Precious Metals	43.2
Pacific/Asia ex-Japan	-1.6	Pacific/Asia ex-Japan	13.6
Diversified Pacific/Asia	-1.9	Diversified Emerging Mkts.	6.5
Diversified Emerging Markets	-3.4	Real Estate	-1.1
Laggards			
Utilities	-21.9	Communications	-50.8
Natural Resources	-21.6	Technology	-44.1
Precious Metals	-21.3	Utilities	-37.5
Small-cap Growth	-18.2	Health	-33.9

EQUITY FUNDS

4-week total return	%	52-week total return	%
Leaders			
ProFunds UltraBear Inv.	45.9	Rydex Dynam. Venture 100	100.9
Rydex Dynam. Tempest 500	45.7	ProFunds UltraShort DTC	95.6
Comstock Part. Cap. Val. A	25.4	ProFunds UltraBear Inv.	92.8
Rydex Dynam. Venture 100	23.2	Matthews Korea	92.1
Laggards			
ProFunds UltraBull Inv.	-34.0	ProFunds UltraShort DTC	-75.4
U.S. Glob. Wrld. Prec. Minls.	-30.3	Elite New Opportunity	-62.4
Select Sector SPDR Utilities	-29.6	INVESCO Telecommuns. Inv.	-61.6
Galaxy II Utility Index	-29.3	iShares Gold. Sachs Netwkg.	-61.6

Interest Rates

KEY RATES

	July 24	Week
MONEY MARKET FUNDS	1.43%	1.4
90-DAY TREASURY BILLS	1.67	1.7
2-YEAR TREASURY NOTES	2.29	2.6
10-YEAR TREASURY NOTES	4.46	4.6
30-YEAR TREASURY BONDS	5.34	5.4
30-YEAR FIXED MORTGAGE†	6.34	6.4

†BancQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENT

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 30% federal tax rate.

	10-yr. bond
GENERAL OBLIGATIONS	3.95%
TAXABLE EQUIVALENT	5.64
INSURED REVENUE BONDS	4.10
TAXABLE EQUIVALENT	5.86

THE WEEK AHEAD

CONSUMER CONFIDENCE Tuesday, July 30, 10 a.m. EDT ► The Conference Board's July confidence index is forecast to have fallen to 102.3, from 106.4 in June. That's based on the median forecast of economists surveyed by Standard & Poor's MMS, a unit of The McGraw-Hill Companies.

GROSS DOMESTIC PRODUCT Wednesday, July 31, 8:30 a.m. EDT ► The economy is expected to have grown at an annual rate of 2.5% in the second quarter, after a

6.1% surge in the first quarter. A ballooning trade deficit and a slowdown in inventory liquidation cooled growth.

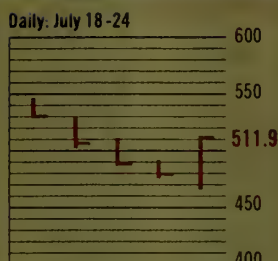
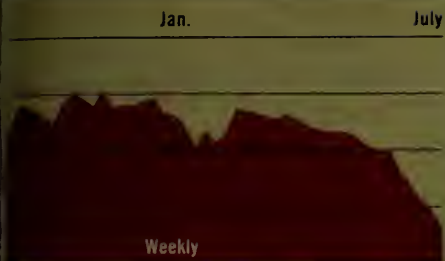
BEIGE BOOK Wednesday, July 31, 2 p.m. EDT ► The Federal Reserve Board releases its survey of regional economic activity ahead of its Aug. 13 policy meeting.

PURCHASING MANAGERS' INDEX Thursday, Aug. 1, 10 a.m. EDT ► The Institute for Supply Management's industrial-activity index most likely fell to 55.5% in July.

EMPLOYMENT Friday, Aug. 2, 8:30 a.m. EDT ► Nonfarm payrolls in July most likely increased by 68,000 jobs. The unemployment rate probably held at 5.9%.

PERSONAL INCOME Friday, Aug. 2, 8:30 a.m. EDT ► Personal income in June most likely rose 0.4%, while consumer expenditures are forecast to have risen 0.5%.

FACTORY INVENTORIES Friday, Aug. 2, 8:30 a.m. EDT ► Manufacturing inventories most likely slipped 0.1% in July.



3% in a week in which only three companies in the index—Philip Morris, Bed Bath & Beyond, Financial—eked out gains. Among the losers, Dynegy led the decline, falling a steep 81.4% downgrade. Also hurt by bad news were Tyco International, down 16.5%, on worries of weak and Citigroup, which declined 19.9% on worries about its exposure to Enron and WorldCom.

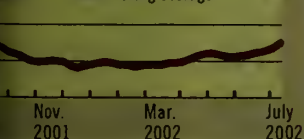
COMPANY PERFORMANCE

	% change		Rank	Company	% change	
	Week	Since 3/1/02			Week	Since 3/1/02
Johnson	-6.9	-21.7	26	Tenet Healthcare	-6.8	-23.4
	-1.0	-8.1	27	Household International	-5.7	-22.4
	-4.7	-31.9	28	WellPoint Health Networks	-0.8	24.6
	-9.6	-51.8	29	Washington Mutual	-2.9	3.0
	1.2	-15.2	30	Duke Energy	-1.6	-37.5
Bergen	-5.2	-26.9	31	Kohl's	1.2	-5.4
	-3.5	-10.5	32	Bed Bath & Beyond	1.3	-6.0
	-1.8	-17.1	33	Cardinal Health	-6.6	-22.5
	-2.8	-30.3	34	Centex	-2.6	-18.5
	-3.6	-8.2	35	American Electric Power	-23.6	-40.0
Group	-4.1	22.4	36	Golden West Financial	-4.3	-6.5
	-1.8	-10.7	37	Stryker	-11.2	-26.1
	-0.5	-38.6	38	Harley-Davidson	-4.3	-9.6
	-0.6	-22.7	39	PepsiCo	-6.7	-21.7
	-81.4	-96.2	40	Merck	-4.3	-30.5
amics	-5.1	-5.8	41	Apache	-5.6	-7.8
	-7.8	-19.2	42	Amerada Hess	-12.6	-5.3
	-6.0	-12.0	43	KB Home	-2.4	2.5
	-4.9	-12.0	44	First Data	-3.3	-15.5
	-28.3	-48.3	45	Tyco International	-16.5	-65.6
Petroleum	-6.1	-7.6	46	International Game Technology	-3.9	-21.3
	-6.7	-22.9	47	Capital One Financial	9.3	-32.4
	-0.2	-10.9	48	Electronic Data Systems	-2.8	-44.1
	-7.5	-19.0	49	Nabors Industries	-6.2	-15.5
	-19.9	-34.6	50	Xcel Energy	-21.3	-50.1

Production Index

Change from last week: 0.7%
Change from last year: -2.3%

OUTPUT July 13=164.8 1992=100
Index is a 4-week moving average



Index grew at an accelerated pace during the week. Before calculation of the four-week adjusted basis, lumber and crude-oil registered the largest gains, with steel and railroads rising. Vehicles were mixed with auto assemblies down, as manufacturers reported annual changeovers. Coal and electric power were lower.

For more index components is at www.businessweek.com
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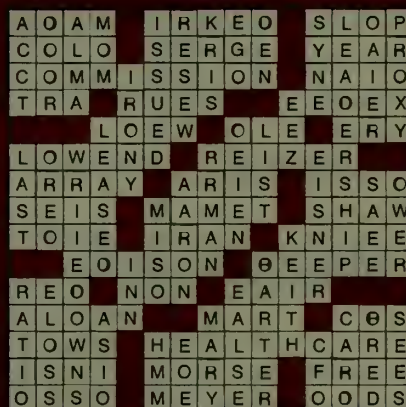
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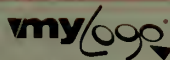
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A CLOSER LOOK AT PROFITS

As companies release their second-quarter earnings figures, it's still tough to gauge the true health of the corporate sector. According to the latest filings of companies in our flash profits sample (page 50), corporate profits were down 30% compared with a year earlier, which was a weak quarter to begin with. But take out AT&T and Lucent Technologies Inc.—which accounted for \$20.6 billion in losses all by themselves—and the remaining 123 companies were up by 14%, more than expected.

The confusion in the profits numbers reflect the crosscurrents in the economy and the financial markets. On the one hand, there's plenty of bad news. Stock markets are still way down in the U.S. and abroad, and the scandals have touched some of the country's largest banks. Telecom and energy companies are in trouble no matter where you look, technology companies are reducing their forecasts for the rest of the year, and many large corporations may be forced to start putting money in pension funds for the first time in years (page 44).

However, despite the drumbeat of negative news, there's still some reason for cautious optimism about profits in coming quarters. The key is that by cutting workers and boosting productivity, companies seem to be taking the steps they need to trim costs and increase profits going forward. In recent days, Lucent, General Electric, SBC Communications, and Intel have all announced job reductions. And economic growth, while not stellar, remains positive.

While the news is still dominated by corporate scandal and huge bankruptcies, it may be time for shell-shocked investors to start paying attention to profits. Earnings are by far the biggest influence on stock prices. In the bear market of the 1970s, for example, corporate profits adjusted for inflation were basically flat, and so were stocks. Conversely, the boom that started in 1995 was preceded and accompanied by a major-league runup in profits.

The same connection holds today. It's no coincidence that earnings per share peaked in the first quarter of 2000 and the market hit its high and started downward. Once profits start to rise, on a sustained basis, will the stock market recover.

Of course, after all the reports of financial hocus-pocus, investors are understandably wary of earnings figures put out by corporations. But with all the attention paid to corporate accounting these days, CEOs are going to be more reluctant to adopt the sort of aggressive accounting practices that they used in the past. That trend toward honesty will be reinforced by the requirement that, starting Aug. 14, CEOs must certify their financial reports as honest and correct.

As a result, there's a reasonable chance that the numbers will be cleaner than they have been in a long time. When published earnings start to rise, that's a good sign for investors.

HOW NOT TO CONDUCT BUSINESS

Back in May, 2000, *BusinessWeek* highlighted Jack B. Grubman's enormous influence in the telecom industry—and his enormous conflicts of interest. He was Salomon Smith Barney's lead telecom analyst, even while he helped Salomon raise billions in debt and equity for both existing and upstart telecom companies and gave strategic advice to telecom executives such as Bernard J. Ebbers of WorldCom Inc., including attending some WorldCom board meetings. He even boasted about it at the time, telling *BusinessWeek* that "what used to be a conflict is now a synergy."

Wrong—it was a conflict of interest of the worst kind (page 34). As the telecom bubble began deflating in 2000, Grubman and his band of telecom executives refused to admit publicly that the growth they had predicted simply wasn't happening. Rather than offering objective analysis, Grubman issued optimistic reports. When other analysts made more skeptical forecasts, as in the case of telecom startup Winstar, Grubman made withering rebuttals. At the same time, his pet companies, such as WorldCom, manipulated accounting and used tricks to show more growth and profits than were really there. Meanwhile, ordinary investors, with nowhere to turn to get the real story, lost trillions.

Now the U.S. telecommunications industry lies in ruins, and it has the potential to damage the entire economy. Grubman is under investigation by New York Attorney General Eliot Spitzer and the National Association of Securities Dealers, and many of Grubman's favored companies have either gone under or are facing intense scrutiny from investigators.

While Grubman is an extreme case, he exemplifies a broader problem of conflicts of interest on Wall Street. It's always tempting to skew analysis and research in order to win investment banking business: The bigger the reward, the bigger the temptation. Indeed, given the hundreds of billions in capital that the telecom industry raised during the 1990s, it was one of the all-time richest sources of profit for the Street.

The Grubman affair is a lesson in how not to conduct business. That's why Wall Street firms need to put up walls between analysts and investment bankers. Those steps have already been taken, the result of Spitzer's actions against Merrill Lynch & Co. But more action, by regulators and Wall Street firms, is needed to avoid more versions of the telecom fiasco.

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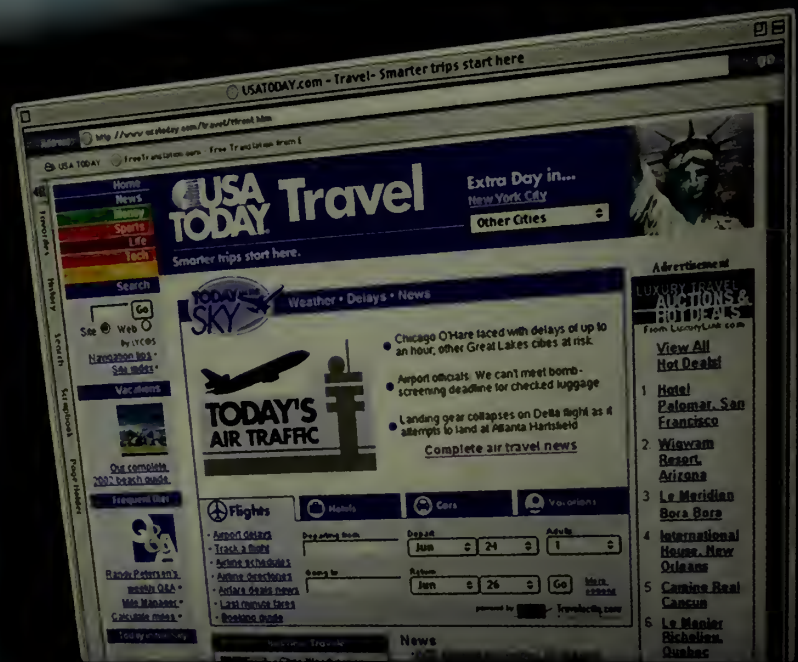
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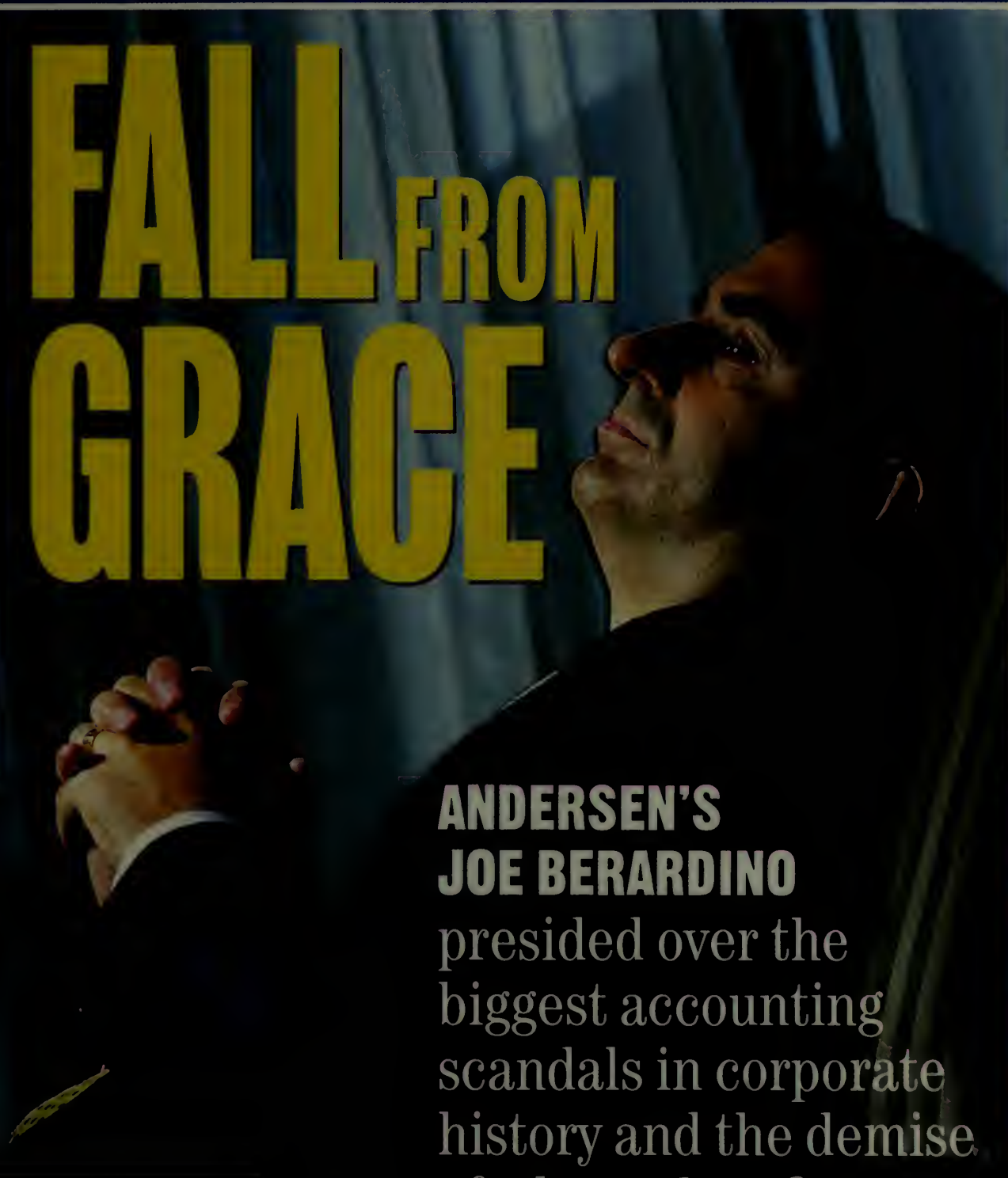
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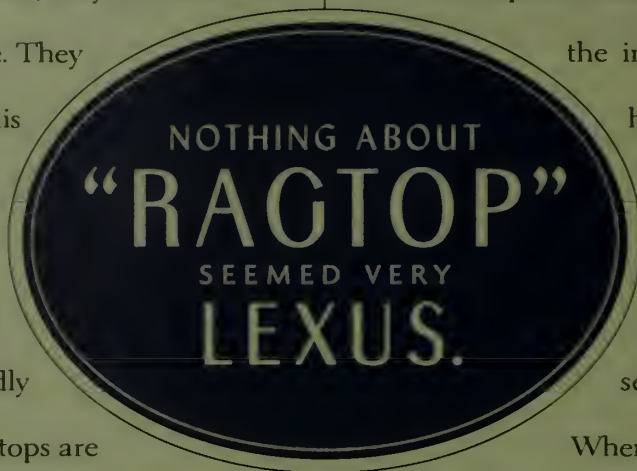


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When Lexus engineers set out to build the SC 430 hardtop convertible, they were not just building a convertible. They were building a Lexus. This is no small distinction. You see, your traditional ragtop may offer the thrill of an open sky, but it's hardly a bastion of comfort. Ragtops are noisy. They are renowned for leaking both air and water. Now that's not very Lexus-like, is it?



No, a Lexus convertible would have to have the requisite luxuries of its brethren. The ingenious, elegant SC 430 hardtop convertible. It has a power window button and the SC 430 hardtop gracefully lowers in a matter of seconds, no less. When the top is up, the SC 430 is transformed into a secure, weather-resistant sport coupe. Put the top down and it's your



DATE DUE

ky and its potent 4.3-liter, 300-hp V8
e 'to keep all this power under control,
SC 430 is equipped with Vehicle Skid
rol,* Traction Control and anti-lock brakes.
uge 18-inch alloy wheels,† with available
ut, low-profile tires,‡ hug the road and
ince its sport coupe intentions.

it, if the SC 430 performs like a sports car,
eeling behind the wheel is remarkably
ed. A windshield-high cockpit cowl and

rear-wind deflector reduce wind d... ave
Climate Control senses and then automatically
regulates cabin temperature, even in the face
of a changing sun. Hand-stitched fine leather
trim caresses eye and skin and is accented by
burled walnut or bird's-eye maple trim. Both
front seats are power-adjustable and heated.

In short, the SC 430 stands uncompromised.
And while this may not be very common in a
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BusinessWeek

AUGUST 12, 2002

COVER STORY

FALL FROM GRACE

Joe Berardino and the culture of denial that helped topple once-mighty Andersen page 50

Cover Story

50 FALL FROM GRACE

Joseph Berardino was at the helm of Andersen when the firm was convicted of obstruction of justice during the biggest accounting scandals in corporate history. The debacle so far has cost investors more than \$300 billion and put tens of thousands out of work. Insular and inbred, the legendary accounting and consulting colossus was unable to respond swiftly to crises, and its collapse represents an unimaginable failure of leadership and governance

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STRONG: TECH & YOU
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Up Front

EDITED BY SHERIDAN PRASSO

ENRON END RUNS

THE REAL STORY OF THE WATKINS MEMO

NEXT UP IN THE convoluted saga of Enron: the tale of Schuyler Tilney, a senior Merrill Lynch investment banker who took the Fifth in front of Congress on July 30. Tilney had more than just a professional relationship with Enron. His wife, Elizabeth, was once a senior member of Enron's management team and "one of the closest confidantes" of former CEO Kenneth Lay, according to a source with detailed knowledge of Enron. And Schuyler, personally, was an investor in LJM2, one of the off-balance-sheet partnerships used to conceal Enron's losses.

More surprising, after Sherron Watkins wrote her famous whistle-blower memo, Lay sent her to talk to Elizabeth Tilney. Elizabeth had previously overseen Enron's corporate communications and marketing and had worked on an internal employee "values" campaign. At the time Lay sent Watkins to her, she was handling communications



TILNEY: Married to Enron management

and marketing for a subsidiary, Enron Energy Services. So Watkins wrote a second, two-page memo to Elizabeth suggesting that she have Lay go public about Enron's shenanigans, including the LJM partnerships. Watkins wrote: "It's very hard to know who in the organization is giving us good answers and who's covering

TALK SHOW "If you're a CEO and think you can fud books in order to make yourself look better, we're going to find you, we're going to arrest you, and we're going to put you to account." —President George W. Bush

their prior work."

It sure was. At the time, Watkins did not know that she was taking her complaints to the wife of the investment banker who helped

Merrill Lynch win the job to raise funds for the LJM2 partnership and who had his own financial stake in it, according to Watkins' lawyer, Philip Hilder. The conversation between the two women was "a one-way street," says Hilder. "They [Enron management] wanted Sherron to have limited involvement." Some of her Enron colleagues questioned Elizabeth's apparent conflict of interest at the time, the source says.

The Tilneys' lawyer, Robert Trout, says there was no conflict, that Elizabeth was assigned to a subsidiary and had disclosed her husband's role to top management: "Ms. Tilney had no authority to pick or choose among the many opinions about how to deal with the situation."

Shows how seriously Lay took Watkins' first memo, doesn't it? A spokeswoman for Lay says that he has no response.

Emily Thornton
and Wendy Zellner

AT THE TROUGH

WORLDCOM: A GOTO THE LAWYER

RULE NO. 1 IN A BANK The lawyers get paid. And in the case of WorldCom, there seems to be a race to the trough. The firms, plus investment banks Lazard Frères, are getting the long-distance remaining nickel in the way. Three are billing WorldCom at or above the unheard-of rate of \$1,000 an hour.

Topping the list is McLucas of Wilmer, Cutler & Pickering. He's getting an hour from WorldCom board to investigate the company's dubious accounting activities. That is \$65 more than he got for doing the same at Enron. A respected former Securities & Exchange Commission enforcement chief, he cautions his price to troubled firms is not to show how they're getting clean. McLucas says up to his firm how much he bills.

Superlobbyist Tom Boggs is also billing \$1,000 an hour to contain damage from congressional inquiries. Lawyers at leading bank firm Weil, Gotshal & Mander are pulling in that amount as well. Neither Boggs nor Weil Gotshal lawyers comment.

Hundreds of other law firms, associates, and paralegals are billing for lesser amounts, pending on level of involvement. And many firms have even been named yet in Lazard, which wants a million "success fee" if it helps up restructuring WorldCom and the bankruptcy fee will end up being the biggest record.

THE LIST McMARKETING

Suffering from flat domestic growth over the past several years, the world's biggest fast-food chain is rolling out new retail concepts in test markets across the country. A sampling:

MCDONALD'S WITH DINER INSIDE

Kokomo, Ind.
Waiter service with a more varied menu; for example, chicken-fried steak in addition to Chicken McNuggets.

McDONUTS

New York
An experimental move into Krispy Kreme's territory. A similar local experiment was responsible for the Big Mac.

INTERNET ACCESS

Atlanta
Computer stations installed by Freddie Mac in two franchises, linked to Freddie Mac's homebuyer Web site and the Net.

SPAM BREAKFAST PLATTER

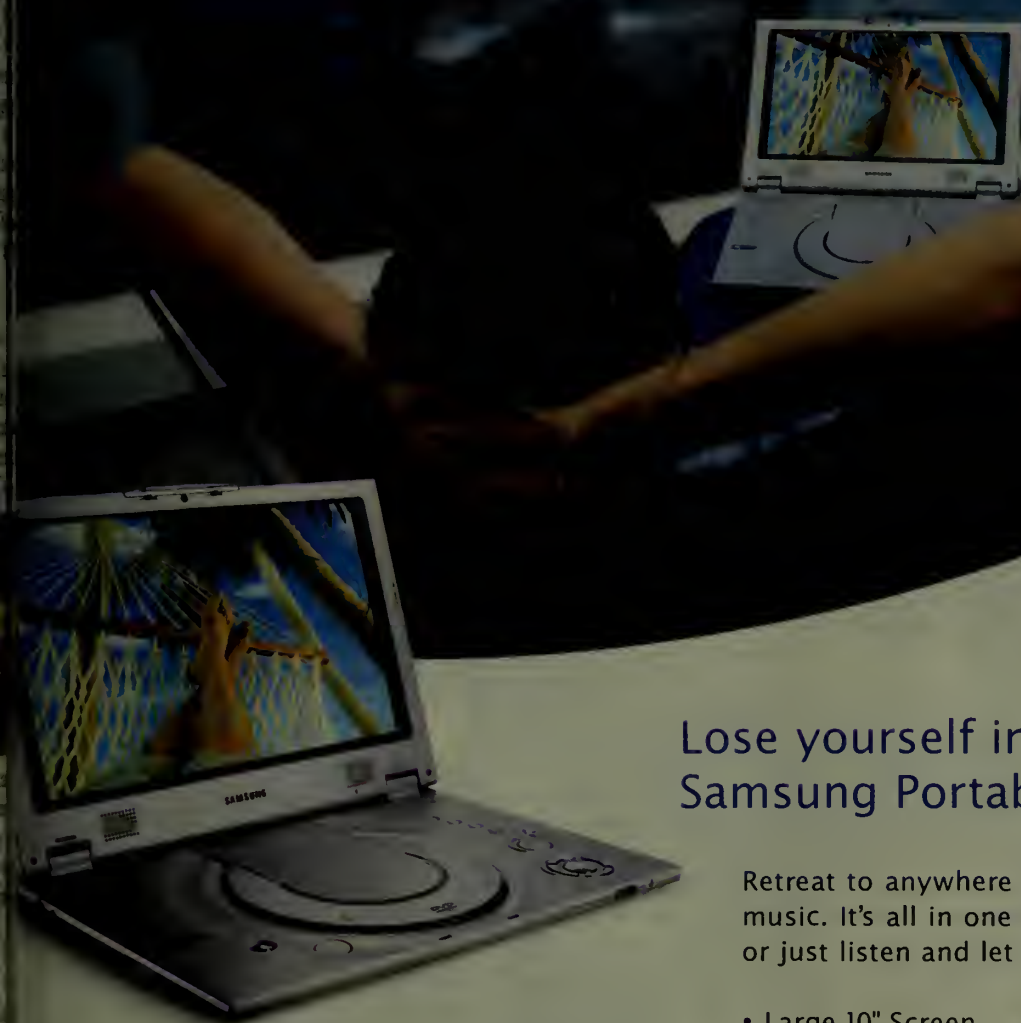
Hawaii
Hawaiians ordered 3,000 of them the first day the item appeared on menus in June at the state's 78 McDonald's.

TOWN CENTER

Columbus, Ohio
A mega-McD's with areas for adults and kids. The tween set can have a night out at the restaurant's karaoke booth.

SAMSUNG

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Up Front

TAXING MATTERS

SOCIAL CONSCIENCE WITH THAT LATTE?

SEATTLE COFFEE DRINKERS could soon find their lattes carrying an extra jolt—a 10¢ tax. The tax would be levied on all espresso drinks, not regular coffee, sold in Seattle.



EXTRA CHARGE? *Seattle will vote*

The money would fund better wages for child-care workers and subsidize day care for poor kids. Organizers say they've got more than the 17,000 signatures needed to get the proposal on November congressional ballots. It needs a majority to pass.

SPORTING LIFE

NEXT TIME, JUST GO FOR IT

PRO FOOTBALL TEAMS KICK too often on the fourth down. Says who? A 6-foot, 170-pound economist out of the University of California at Berkeley. David Romer did a statistical analysis of every play in more than 700 National Football League games from 1998 to 2000.

His findings: A team that's near mid-field on the fourth down should try for a first down—rather than punt or attempt a field goal—as long as it's within five yards of making it. A team should also try for

Taxing espresso in a city of coffee junkies might seem cause for uproar, but organizers say their polls show 74% of Seattleites favor it. That doesn't include Starbucks, however, which says it does not "fully understand" why espresso should be taxed. Or the Seattle Chamber of Commerce, which says the tax would unfairly burden small shops. The Chamber has its own follow-up research showing 70% opposition to the tax.

Supporters say the tax is too small to dent sales and would mostly hit the well-off. "For a very small tax, you can really generate a sizable sum," says Laura Paskin, spokeswoman for Seattle's Economic

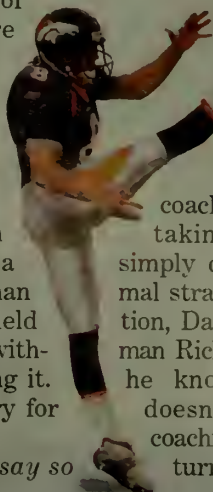
Opportunity Institute, a think tank that supports the tax. It predicts revenue of \$7 million in the first year. (That's 70 million espressos.)

So where do Seattle residents really stand? We'll find out in November. *Kimberly Weisul, with Hunter Hardin*

a touchdown if it's within five yards of the goal line on the fourth down.

That's far more daring than the plays you'll see on any given Sunday. In his National Bureau of Economic Research working paper—which contains more Greek letters than Fraternity Row—Romer says teams kicked on 992 of 1,100 fourth downs when they should have gone for it.

Romer guesses that coaches fear criticism for taking risks—or they simply don't know the optimal strategy. Asked for reaction, Dallas Cowboys spokesman Rich Dalrymple says: "If he knows so much, why doesn't he get a job in coaching? There's plenty of turnover." *Peter Coy*



WRONG MOVE? *Stats say so*

DRAWN & QUARTERED



HAPPY RETURNS

SO THAT'S WHY MARRIED MEN GET PAID

A PUZZLING FACT HAS LONG drawn the scrutiny of economists: Married men make more money than bachelors.

In fact, they make 11% more than men who have never tied the knot, according to a recent, comprehensive study by the Federal Reserve Bank of St. Louis.

Senior research associate Abigail Chiodo and economist Michael Owyang reviewed at least seven other studies by academic researchers going back to the early 1980s and found this to be the case, even when the data were adjusted for the men's

work experience, education and age.

Their key discovery: Women look for in a man the same as what com-



look for in a employee. Desirable attributes include responsibility, loyalty, the ability to solve conflicts.

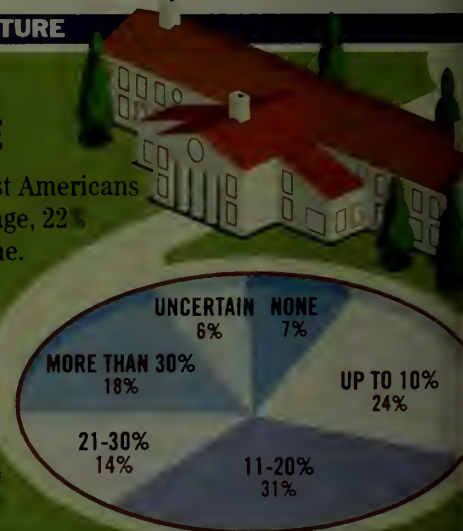
Appearance helps. As Owyang and Owyang find in their study, "Physical attractiveness—normally associated with desirability as a mate—tends to have a positive effect on wages."

So much for that raise. *Laura*

THE BIG PICTURE

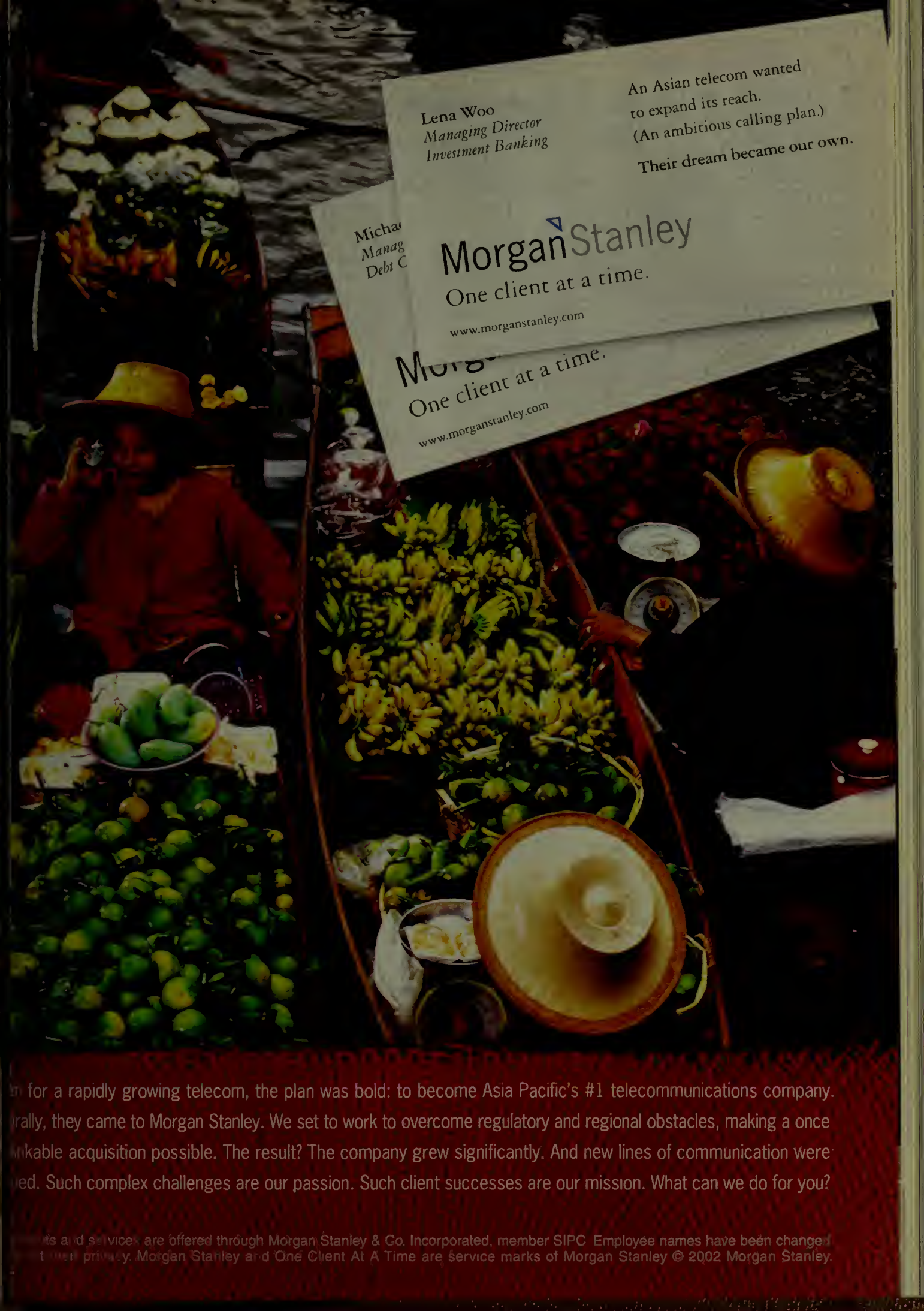
WHAT THE RICH SAVE

The wealthiest Americans save on average, 22% of their income. Here's the breakdown:



150 respondents with annual income of \$30,000 or more, with over \$3.75 million. Conducted June 2002.

Polls, surveys, and other items for consideration in this section should be sent to upfront@businessweek.com



Lena Woo
Managing Director
Investment Banking

An Asian telecom wanted
to expand its reach.
(An ambitious calling plan.)
Their dream became our own.

Michael
Managing
Debt Capital

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for a rapidly growing telecom, the plan was bold: to become Asia Pacific's #1 telecommunications company. Initially, they came to Morgan Stanley. We set to work to overcome regulatory and regional obstacles, making a once unthinkable acquisition possible. The result? The company grew significantly. And new lines of communication were opened. Such complex challenges are our passion. Such client successes are our mission. What can we do for you?

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IT'S THE SYSTEM, STUPID

The current financial mess requires nothing more than enforcement of existing laws by the Justice Dept., Federal Trade Commission, and Securities & Exchange Commission ("Let the reforms begin," Cover Story, July 22). The failure of these agencies to draw the lines encouraged companies (in fact required them, in order to remain competitive) to violate existing laws. There was no possibility of criminal liability, almost no possibility of civil action by government agency causing the companies to give up more than they stole, and civil cases for relief are routinely tossed out of court.

The best action would be to create a statutory remedy for shareholders to challenge specific types of corporate wrongdoing (excessive compensation, false financial statements, sweetheart deals, etc.), without the class-action-type restrictions that stifle most potential lawsuits of this type. Modeled on a whistleblower incentive basis, suing shareholders and their lawyers would be entitled to a percentage of any recovered money or property from the corporation.

Carl E. Person
New York

What the public most wants to see is "insiders" returning the hundreds of millions of dollars received as incentive compensation by "mistake." There is no need to prove fraudulent behavior. If a real accounting shows that incentive targets were not achieved, the money and options should not have been paid

in the first place and must be recovered. Boards of directors have a fiduciary duty to get back their companies' money even if the recipients are their friends. Recovering the money will reduce the number of future "bad apples."

Jerome H. Groves
Glen Cove, N.Y.

Banks should be required to send their analyst departments into securities research companies so that the research they provide is independent in both content and appearance. Analysts have

too much importance in meeting earnings estimates and, in turn, have conditioned investors to vesting public into tolerance for volatility and any earnings surprises," bad or good.

The investing public needs to accept a degree of equity market volatility. Then, executives could be managing their earnings and focus on running businesses more

efficiently and effectively.

Craig I. Nevel

For years, in its Cover Stories, *BusinessWeek* has celebrated business leaders and corporations that turn out to be frauds. "Corporate crime's new cop" (Cover Story, July 22) is still a puff piece about Deputy Attorney General Larry Dean Thompson. You know that he gives Bush "credibility" and "he carries little political baggage."

As has been revealed elsewhere, a corrupt law-enforcement officer was head of the audit and compliance committee of Provident Financial Bank.



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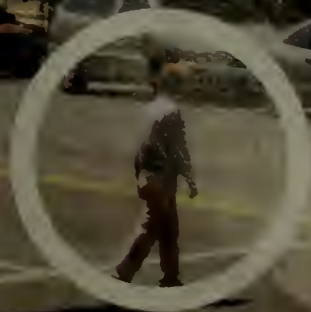
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Readers Report

CORRECTIONS & CLARIFICATIONS

In "False alarm at Manor Care" (Inside Wall Street, Aug. 5), analyst Albert Rice of Merrill Lynch was mistakenly identified as owning shares in Manor Care. He does not own shares in the company.

the same time it was engaged in a \$400 million fraud.

Do your readers have to question your credibility on every article, just as we now question the financial reports of Corporate America? Stop covering up for the crooks running the country.

Douglas Caddy
Houston

"The ghosts that won't go away" (Cover Story, July 22) looks for a few places where Democrats have struck matches, and it tries to fan the flames. Any one of the Democrats quoted has done more questionable (illegal) deeds than Bush. This is particularly so if we include campaign finance. George W. Bush has been more straightforward in his dealings with the public [relating to] his corporate dealings and his personal finances than any of the people lighting matches in this article.

Charles S. Harris
New Carlisle, Ohio

"It's time for a new era of reform" (Editorials, July 22) is much too accommodating of the offenders in this financial scandal. From so-called aggressive accounting to outright misrepresentations by self-serving corporate officers, the damage thus far has been severe and is headed toward catastrophic. The images of politicians asking "probing" questions of corrupt corporate officers, from whom they have accepted political contributions, bear an eerie similarity to the last days of the Roman Empire.

Prompt action is critical.

William G. Isherwood
Sacramento

WHY NOT TRY PAY CUTS FOR POOR PERFORMANCE?

Is something wrong here? Has anyone in American business ever heard of a pay cut ("An overdose of options," Finance, July 15)? If a company is not doing well, why continue to enhance the pay packages of the managers and executives responsible for the reduced economic value of the corporations and stockholders who employ them?

Donald R. Schreiber
Supply, N.C.

CORPORATE CRIME-AND WASHINGTON'S PART IN IT

I agree with the assessment of Baxter International Inc.'s CEO Harry Kraemer Jr. We don't need more laws: What we need is people with a higher level of integrity to run our corporate institutions ("Too many rotten apples," News: Analysis & Commentary, July 15). We complain about corruption in Argentina, China, Columbia, Mexico, Nicaragua, Russia, etc., but the level of corruption in those countries pales when compared with what we have here in the U.S. We just happen to do it in a business suit with lawyers, accountants, bankers, and Wall Street analysts.

Joseph Pugliese
Macungie, Pa.

How can we expect politicians to crack down on corporate fraud when most have been bought and paid for with campaign donations? Corporate crime and political contributions are two sides of the same coin. If Senator Phil Gramm (R-Tex.), whose wife was an Enron director, had any sense of ethics, he would recuse himself from any discussion of corporate reform. Don't his fellow legislators recognize the conflict of interest? They must all be tainted.

Diane E. Shepherd
Kihei, Hawaii

It's time for the government to stop enabling accounting fraud ("Let's really clean up those numbers—now," News: Analysis & Commentary, July 15). The Internal Revenue Service and the SEC let companies keep two sets of books, one for tax reporting and the other for financial reporting. There should be no difference in the figures corporations report to the IRS and SEC. The combined surveillance and enforcement by these agencies of one set of books and identical tax and financial reports should give the investing public a clearer picture of corporate performance.

George C. Heidrich
McLean, Va.

In "The economy is falling down around their ears," News: Analysis & Commentary, July 15), House Minority Leader Richard A. Gephardt (D-Mo.) states: "We have got to... see [if] needed regulations were relaxed or changed wrongly." I suggest Gephardt start his witch-hunt by taking a hard look at the Clinton Administration's eight years in office. Never has a nation seen so much immorality and abuse of power in their efforts to grab power in order to

implement their social agenda. Not only all of the poor corporate governance started or took place during the regime.

Edward
Los Altos

EXECUTIVE PRESENCE: THE LAST THING WOMEN NEED

I can't think of worse timing than Michelle Conlin's article on convincing women managers to project "it," emphasizing executive presence, which translates into emphasizing form over substance ("She's gotta have it," Business Investor, July 22). America does not need its women managers to be co-opted into this old boys' club, where image is more important than understanding business or ethics.

Glitz got us into this earnings trap. More glitz won't get us out.

Ronald
Binghamton

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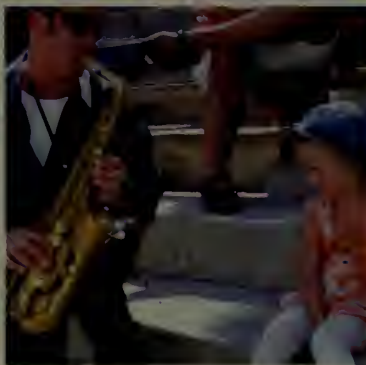
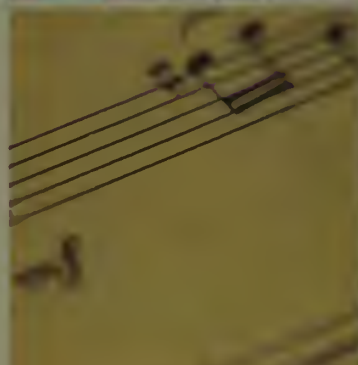
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WATER EVERYWHERE... DID NOT A DROP TO DRINK?

summer, for most of us, means water-soaked fun at a pool, lakeside, or beach. But as we nonchalantly mope about, the world's water supply is perilously threatened. Consider some of this summer's headlines: Unprecedented wildfires in Arizona fueled by record-dry brush. Hyper-shortages in the Pacific Northwest. Creeping desertification of farmland in the Southwest, Central Africa, and Asia. The situation is dire and getting worse.

A crisis that goes largely unacknowledged. The real danger is two recent books, one by the developed world's water mastery over water, and the other a false sense of security. In *Blue Gold*, activists Maude Barlow and Tony Clarke offer an angry and persuasive account of how this has damaged the environment and how the privatization of once-public water resources tends to exacerbate the problem. *Water Wars*, conservationist Diane Raines Ward provides a less polemical, more engaging story of "drought, flood, folly" across the planet.

Both books marshal abundant data to support their conclusions. Global consumption of water is doubling every 20 years, twice the rate of population growth, observe Barlow and Clarke. Pesticides, toxins from cities, factories, and agriculture are spoiling freshwater supplies: more than half the world's rivers are polluted. Meanwhile, as Ward details, the fight around the world are engaged in a losing fight against rising sea levels. Sometimes, the books' flow of statistics can be numbing. For example, *Blue Gold* notes that the earth has 330 million cubic miles of water, but just 8,000 cubic miles available as circulating freshwater. Is that a lot or a little? The authors more than compensate

for such lapses, while tackling the crisis from different angles. *Blue Gold* describes the moneyed interests plunging into the water business. It tells how Perrier, Evian, Coca-Cola, PepsiCo—and particularly the French giants Vivendi and Suez—are buying up rights to mine free public aquifers, then bottling and selling their products around the world. *Blue Gold's* central question: Is access to water a fundamental right, or is water a salable good? If it's a right, then countries have a duty to distribute water to their citizens. But if considered a good, water gets caught up in the calculus of profit maximization.

Clearly, the authors are in the rights camp, holding that local communities should set water policy. But they make a strong case that the water-as-commodity view is winning. A spate of rulings by the World Trade Organization, the International Monetary Fund, and the World Bank treat water as an economic good. And many poor countries, unable to afford the capital costs, have invited private companies to run their water systems, sometimes ceding control to foreign interests. "Maximizing profit is the prime goal, not ensuring sustainability or equal access to water," write Barlow and Clarke.

Their stance is well-served by a description of U.S. engineering giant Bechtel Group Inc.'s disastrous 1998 investment in the water system of Cochabamba, Bolivia. To recoup its spending on infrastructure, Bechtel raised water fees so high that the poor could not afford them. The resulting riots led to the ejection of Bechtel and

the return of the assets to public management. "Cochabamba" has since become a rallying cry for activists opposing similar privatizations elsewhere.

Water Wars, despite its action-movie title, doesn't draw such sharp lines between good and bad. Ward's intent is to describe mankind's complex relationship with water. She is fascinated by such megaprojects as Holland's \$8 billion system of storm-surge gates that can seal off Rotterdam harbor from North Sea storms. Visiting the ruins of a 5,000-year-old dam in the Egyptian desert, she reflects that the urge to find, dam, and channel water is one of the earliest spurs to technological advancement.

Yet Ward is saddened by our destructive treatment of water. Evaluating megascale projects, she finds that many costs come with the benefits. Dams, for example, are built to irrigate land for farming. But poorly designed dams let sediment accumulate behind them, starving downstream farms of nutrients.

Indeed, many of the 20th century's greatest victories are double-edged when it comes to water. Ward talks to countless people caught up in the contradictions. One is Jacobus Van Dijk, director of the Netherlands' water-control bureau, who lives on a farm below sea level. He explains how the centuries-old Dutch obsession with holding back the sea has resulted in some of

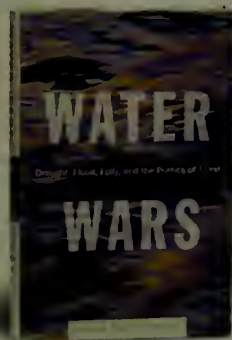
the world's most uneconomic farmland, maintained only by a massive network of dikes and pumps. Like much of Ward's book, the tale is at once compelling and sad.

Both books suffer from lack of illustrations. They're packed with explanations of water-control structures and the physical features of the hydrosphere—but rely on words alone to tell how over-irrigated

land can turn snow-white with deadly salt, or where the shrinking Ogallala Aquifer in the Western U.S. lies.

Still, the words alone are plenty to inspire and alarm. *Blue Gold* will make you want to waste less water, while *Water Wars* may induce you to visit the Hoover Dam. Together, they make the point that the lifeblood of planet earth can't be taken for granted.

BY ADAM ASTON
 Aston is Industries editor.



THE WORLD'S TECHNICAL MASTERY OVER WATER MAY HAVE LED TO A FALSE SENSE OF SECURITY

BY LARRY ARMSTRONG

tech&you@businessweek.com

ALL QUIET AT 35,000 FEET



The latest headsets will spare you the tiring roar of jet engines—or the lawn tractor

I had suspected that a recent flight, a puddle-jumper from Seattle to Victoria, B.C., might be a noisy one. Sure enough, at the end of the pilot's safety briefing, he offered me and my fellow travelers little plastic bags of earplugs.

I declined. I had my own. In my bag were a half-dozen sets of noise-canceling headphones from four manufacturers. I had planned this short trip in a four-passenger float plane as the perfect test. If the headphones could silence a deafening propeller engine, they should have no problem dulling the roar inside the cabin of a conventional jet.

Medical studies have shown that noise, especially low-frequency noise, causes fatigue. You know the problem. Even after a relatively short two- or three-hour plane trip, you arrive at your meeting or hotel feeling tired, and for no good reason. In a week of flying, I found that any of the headsets I tested will eliminate that issue. There's a side benefit, too: You can actually hear the in-flight movie without cranking the volume up to painful levels.

Noise-canceling technology is not new. Pilots have used headsets like these—but versions that cost up to \$1,000—for years, even when they're not at the controls. I discovered the benefits six years ago when the first consumer model appeared, a \$150 headset from NCT Group. Back then, I thought the price was a bit high for audio headphones. But the real problem was that the electronics that create the noise-canceling signal were housed in a heavy, bulky box the size of a pack of cigarettes, and they burned through a nine-volt battery every couple of days.

That has changed over the past couple of years. There are now dozens of models on the market, ranging from \$40 to around \$300. They're powered by one or two AAA batteries good for around 100 hours.

I immediately discovered that price has little to do with how well they work. True, my favorite is the most expensive set, the \$299 Bose QuietComfort model. But a close second is NCT's current pair, the \$40 NoiseBuster Extreme. It's

noticeably less stylish—it looks and feels in fact—and slightly less comfortable than Bose headphones. But it suppresses more frequency airplane noise than any of the

I also looked at Sony's MDR-NC20, about \$70, and Panasonic's RP-HC100, about \$70. Both are big, closed-back-style headphones with the electronics, battery, and on-off switch built into the right phone instead of a separate unit. They fold for travel, unlike the Bose NCT models, but neither could match their noise reduction. At \$40 to \$50, depending where you shop, the lightweight Panasonic HC70 does a better job reproducing music, my favorites, lets you choose the level of suppression. If you don't mind a headset

the speakers fit your ear canals, the Sony's MDR-NC11 goes for \$100 at Internet retailers.

A word about technology, just know the answer to your seatmate. All of the headphones are tiny phones

ed on or inside the headset to play the ambient sound just before you hear it. They take the natural, electronically its exact opposite, and the opposing signal

headset's speakers. The result is that the electronically generated waves from the headset cancel out the sound around you before you can hear it. What's the audio signal that you're plugged into, the plane's audio system, say, or your own MP3 player.

This technique only works for low-frequency sounds, though, which is why they're so good at scrubbing out aircraft noise. They are as effective against other low-frequency noise as well. You might find yourself grabbing them when you mow the lawn, for example, or to hear the TV when you're working out on a treadmill.

To test these gizmos against high-frequency noise, I booked the next leg of my trip on a helicopter. They were pretty useless when confronted with the high-pitched whine of the gears directly above our heads. To get higher-frequency cabin noise, typically screaming infants or overly chatty pilots, you have to physically block it. For that, the closed-back Bose and Panasonic models are good. The Bose completely surrounds your ear and around your head, is even better.

Be warned: You won't be able to hear the flight attendant ask whether you want chicken or fish. But that's no great loss, is it?



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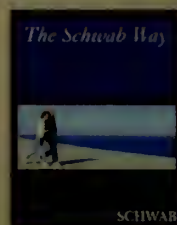
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Tools for the New Work

BY LAURA D'ANDREA TYSON

AFTER IRRATIONAL EXUBERANCE, IRRATIONAL PESSIMISM



DANGER:
Investors
now seem to
be as deaf
to good news
about the
economy as
they were
to warnings
at the height
of the stock
bubble

In December, 1996, Alan Greenspan warned that a wave of "irrational exuberance" was rolling through America's equity market. His warning fell on deaf ears. Enthralled by the promise of the Internet and a deregulated telecommunications market, wooed by media stories of rags-to-riches entrepreneurs, lulled by faith that the Federal Reserve could and would prevent a prolonged stock market collapse as it had in 1987, and cheered by a culture that extolled the pursuit of private wealth as public virtue, investors fed one of the largest speculative booms in economic history.

This boom, like its historical predecessors, created a climate of "infectious greed," as Greenspan recently put it. As in the past, the revelation of scandals nourished by avarice has been a major force behind the boom's gut-wrenching undoing. We may live in an era of new technology and new financial instruments, but the rise and fall of the U.S. stock market over the past six years confirms Harry S. Truman's adage that the only thing new in the world is the history you don't know.

We have now entered the final phase of the boom-bust cycle—the search for villains for past ill deeds and the search for reforms to prevent future calamities. But in the panic to sell shares in U.S. companies, investors are deaf to good news about the resilience and productivity of the American economy just as they were deaf to bad news at the height of the market euphoria.

For the average American, with small holdings in the market, the greatest danger now is not the stock market's collapse. Rather, it's a sharp economic slowdown caused by a mood of irrational despair fed by press and political hype about what's rotten in American capitalism.

Beyond the despair, what are the appropriate policy lessons to be learned from the economy's most recent boom-bust binge? Truthfully, it is too early to know for sure, though that hasn't stopped Congress from passing a massive new corporate-responsibility law whose effects on financial markets and the costs of doing business will be uncertain for years to come. But a few policy lessons have already begun to emerge.

First, compensation packages that link executive rewards to the company's stock performance may work well when stock values accurately reflect underlying fundamentals such as efficiency and competitiveness. But such packages can distort incentives when stock values significantly deviate from fundamentals, as happens when irrational exuberance takes hold or earn-

ings are manipulated by top management.

The great bull market of the 1990s wrought havoc on the pay-for-stock-performance system, allowing corporate leaders to ride the market to huge windfalls of personal wealth, tempting some to artificially inflate earnings to keep stock prices rising.

To avoid these problems in the future, performance-based pay should be structured to reward executives on the basis of a company's performance relative to overall market or industry performance. And to reduce incentives for executives to manipulate earnings to boost stock prices in the short run, companies should impose longer waiting periods between the time executives acquire stock—either through grants or through the exercise of stock options—and the time they are allowed to sell it. Further, reining in grants of stocks and options will help mitigate the yawning gap between executive compensation and worker compensation, a gap that has at its core the public's resentment.

As for the accounting industry, the major problem is that self-policing has failed. An independent accounting regulator is necessary to complement the work of the Securities & Exchange Commission. Both regulatory bodies must be granted the resources and respect they need to do their jobs. In recent years, under a Republican Congress dedicated to slashing discretionary spending and ridiculing government regulation, the SEC has enjoyed neither.

While the nation debates the reforms necessary to prevent another boom-bust cycle, the role of culture should not be overlooked. Greenspan argues that while humans have become greedier, the avenues to express greed have grown enormously. Greed may indeed be a basic human emotion, but surely, human beings can be encouraged to be more or less greedy by the values of the culture around them.

Without question, America's love affair with unfettered market capitalism and a culture that extols greed as public virtue, that sanctions inequalities in income and wealth as fair, that ridicules civic service, and that equates happiness with material success has encouraged more greed at the expense of other human emotions—kindness, empathy, guilt, and a sense of fairness—all of which have been sidelined. If our culture had placed more emphasis on such values, perhaps some of the excesses and swindles of the past few years might have been avoided. Maybe the pairing of greed with material success will trigger a healthy shift in prevailing cultural norms.

Laura D'Andrea Tyson is
dean of London Business
School.



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¹ In 2002 EPA estimates city/highway mileage. Actual results may vary. Calif. Air Resources Board SULEV-rated. For more information, ca.gov. ² Based on hydrocarbons and oxides of nitrogen, compared to the average car. ©2002 Toyota Motor Sales, U.S.A., Inc.

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EDITED BY MARGARET POPPER

REAL ESTATE'S BUBBLE CITIES

Certain markets are full of hot air

One of the miracles of the recent recession has been the way home prices have held up. Average prices of existing homes were 10.4% higher in June, 2002, than they were a year earlier, according to the National Association of Realtors.

THE MOST OVERPRICED HOME MARKETS

HOUSING CYCLE BAROMETER*

BOSTON	9.3	DENVER	7.0
SAN DIEGO	7.8	SAN JOSE, CALIF.	6.9
FORT LAUDERDALE	7.6	ORANGE CO., CALIF.	6.8
SAN FRANCISCO	7.3	CHARLESTON, S.C.	6.5
MIAMI	7.1	NEW YORK	6.1

*INDEX BASED ON CURRENT AND HISTORIC HOME PRICES, PERSONAL INCOME, AND MORTGAGE PAYMENT BURDEN. A SCORE ABOVE 5 IMPLIES A HOUSING BUBBLE

Data: John Burns Real Estate Consulting Inc.

Small wonder that investors have been moving money from the stock market into residential real estate. But now the critical question is: Are we inflating a residential real estate bubble?

"Yes," is the answer in about a third of the major metropolitan areas in the U.S., according to a new study of housing affordability by John Burns, a real estate analyst who runs his own consulting firm in Irvine, Calif. Unfortunately for the residents of Boston, San Diego, and Fort Lauderdale, these areas seem to have the most hot air (chart).

Burns has created a "Housing Cycle Barometer" that measures the affordability of housing in a given metropolitan area, compared with its long-term average. Affordability is based on housing prices, downpayments, mortgage payments, and median annual income.

If housing in an area is as affordable as it has been historically, then the market will get a rating of 5. A rating above 5 means that housing prices and/or mortgage payments have outstripped income growth. Ratings of 7.5 or above point to a bubble that will likely burst at some point, although these markets' momentum could fuel price rises for a while yet, says Burns.

In housing markets that scored from 5 to 7.5, such as New York City, the long-term prognosis is not as clear. Although

housing is less affordable in these markets than it has been historically, that may reflect a permanent lack of housing supply because of space or zoning constraints. Instead of a bubble, "it may be that this is the new reality," says Burns.

In these markets homebuyers should watch for evidence of speculative buying, according to Mark Zandi, chief economist at Economy.com Inc., which has its own real estate study that supports Burns's conclusions. Realtors buying and flipping properties, sales at two to four times the asking price, or a practice of skipping inspections are signs of a speculative market, he says. "If you're seeing 20%-plus price gains on a consistent basis, supply restrictions aren't enough to explain what's going on," Zandi cautions.

THE EURO ZONE IS SHIFTING RIGHT

Labor and benefit laws could bend

Business leaders in the euro zone have long railed against an array of structural rigidities, from stringent laws against layoffs to costly state-sponsored social security systems. But such barriers to economic growth could soon be lowered following a recent shift to the political right in France, Italy, and several other European countries.

France and Italy, the euro zone's second- and third-biggest economies, are taking the lead on reform. France's new conservative Prime Minister Jean-Pierre Raffarin and Italy's Prime Minister Silvio Berlusconi are pushing for private pension schemes that would bail out the public system and reduce the cost to businesses. And both are trying to improve the flexibility of their labor markets by changing layoff laws.

Even Germany, the Continent's largest and most hidebound economy, may soon see reform. In June, the Hartz Commission, a government-mandated committee headed by a senior official at Volkswagen, issued a report showing that jobs could be created by cutting red tape for the self-employed and reducing jobless benefits. Faced with Germany's 9.8% jobless rate and near-

zero growth, the winner of this September's general election will be under sure to implement these findings.

All of these relatively modest reforms will help to reduce rigidities and create jobs, says Jean-François Mercier, economist at Schroder Salomon Barne in London. That could boost gross-domestic-product growth of 3% in the euro zone without creating an inflation problem.

By David Farber

MORE, NOT LESS 'EXTREMELY POOR'

A wider measure of welfare re

In the two years after Congress passed sweeping welfare reform in 1996, loads dropped, the number of single parents finding work surged, and the poverty rate slid from 13.7% in 1996 to 12.7% in 1998. On paper, the government's statistics looked promising. A new Urban Institute study by Sherry Zedlewski, Linda Giannarelli, Joyce L. Ton, and Laura Wheaton finds that, a more complete measure of income for a number of families with income 50% below the poverty line—those termed "extremely poor"—rose from 1996 to 1998.

The study suggests that for families, the hike in cash income, was not enough to offset a decrease in participation in government-assisted programs. The Census Bureau's official figure overlooks the harm some families suffer because it includes only income. The Urban Institute measures disposable income, which adds stamps and earned-income-tax credits to cash income and deducts federal taxes and out-of-pocket child-care expenses.

The drop in participation in benefit programs appears to be partly due to the 1996 reforms. Many families left or chose not to join benefit programs under pressure from the state work rather than collect welfare. They also were put off by the increasingly complex eligibility rules.

The study suggests that the government could raise benefit-participation rates by using the same income standards, wealth tests, and job-hunt requirements for all programs. In states, for example, it's easier to get Temporary Assistance for Needy Families (the technical name for "welfare") than food stamps. Zedlewski says participation could cost state governments up to \$23 billion more.

By Andrew Ross

THE DRAG ON EUROPEAN BUSINESS

PERCENT OF COMPANIES REPORTING STRUCTURAL OBSTACLES TO DOING BUSINESS*



*SUCH AS INFLEXIBLE LABOR MARKETS AND BALLOONING SOCIAL SECURITY BILLS
Data: IMD World Competitiveness Yearbook 2002

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JAMES C. COOPER & KATHLEEN MADIGAN

DIMMER PAST. BRIGHTER FUTURE?

New data show improving prospects for second-half growth

U.S. ECONOMY

Not only are companies restating their earnings but the Commerce Dept. is restating economic growth. Thanks to Commerce's latest barrage of data on gross domestic product, including a bevy of revisions going back to 1999, we now know a lot more about where we have been in this business cycle. More important, the data give us a better idea of where we are going.

As was true in the original data, the recession was not as shallow by historical standards. However, new data show that the downturn began earlier and lasted longer than first thought (chart). Real GDP fell in each of the first three quarters of 2001 instead of only in the third quarter, but the peak-to-trough decline is about the same as the one in the 1969-70 recession, and it was the smallest in the postwar era.

RECESSION: LONGER, BUT STILL SHALLOW



The numbers also clearly show that a solid recovery began in the fourth quarter, despite the impact from September 11. After three quarterly declines averaging 0.8%, growth in the final quarter of last year was 2.7%, a percentage higher than first reported. Growth in the first quarter of 2002 jumped to 5%, although that was 1.1 points slower than

WHAT DOES ALL THIS SAY

about the future? First, progress toward righting one of the economy's biggest imbalances, excess production capacity caused by overinvestment, has been greater than first thought. Second, the numbers show that productivity remains exceptionally strong and continue to support both the rebound in profits and healthy gains in household purchasing power. And third, the data for the third quarter are a lot more encouraging than the top-line GDP number suggests.

Each of the slowdown last quarter reflected payback for the first quarter's exaggerated strength, some of which was "borrowed" from the second quarter as a result of an unusually mild winter that distorted the patterns of car sales, housing, and inventories. The

3% average growth rate for the first two quarters is more indicative of the economy's true performance.

A sharp widening in the trade deficit last quarter, caused by the largest quarterly increase in imports in 18 years, lopped off 1.8 percentage points from the quarter's overall growth rate. The import surge is hardly a sign of domestic weakness, but imports are subtracted from GDP because they are not U.S. output. Overall domestic demand, which includes purchases of imports, rose a healthy 2.8% last quarter.

Consumer spending and housing also posted good gains in the second quarter, although smaller than in the first quarter, and consumer outlays are set to grow at a faster pace in the third quarter. The stock market drop did sap consumer confidence. The Conference Board's index fell to 97.1 in July from 106.3 in June, but that's far from a distressed level.

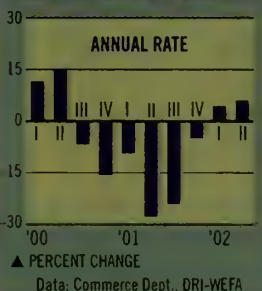
Remember that consumers don't always spend the way they say they feel. Confidence surged in the second quarter, even though spending growth slowed. And in July, despite the market drop, car sales appear to have rebounded strongly from June's level. July mortgage applications remain at a high mark, suggesting strong home buying, and refinancing activity is surging, which always puts extra cash in people's pockets. Confidence may well rebound if the 1,000-point rally in the Dow Jones stock index holds up.

Perhaps the best news from the second quarter was a 2.9% advance in business outlays for equipment and software. The gain, while modest, was the largest in two years. Of note, outlays for information processing and other high-tech gear increased for the second quarter in a row. Plus, despite a June drop, second-quarter orders for capital goods rose for the second quarter in a row, suggesting further gains to come (chart).

THE REVISIONS TO PAST DATA

also bear glad tidings for the future. They show that the downturn was led even more forcefully by cutbacks in business investment. Declines in outlays for new equipment and buildings came sooner and went deeper. Plus, the runup in business investment prior to the falloff was not as

A GRADUAL PICKUP IN CAPITAL GOODS ORDERS



Business Outlook

great as first thought. All this helps to clear the way for a pickup in capital spending.

Commerce's data reconfirm another key trend in this business cycle: Productivity gains and low inflation, which helped to cushion the recession's blow, are still at work fueling the recovery. Taken by themselves, the downward revisions to GDP imply that productivity growth last year was only slightly less than the 2.1% advance originally reported.

The Labor Dept.'s productivity data, due on Aug. 9, will be revised based on the new Commerce numbers, but it will also include updated employment data. The true productivity trends will not be known until then, but it appears that the revisions will be small. Productivity's performance last year will still rank far above that during past recessions.

THE BENEFITS OF PRODUCTIVITY are already showing up in profits. *BusinessWeek's* survey of the second-quarter earnings of some 900 companies shows profits up 8% from a year ago, the first advance in six quarters. Profits are recovering even though weak pricing power held the sales gain to only 1%. That's because unit labor costs have been falling during the past year, reflecting both slimmer payrolls and increased productivity, especially in the fourth and first quarters, when productivity zoomed.

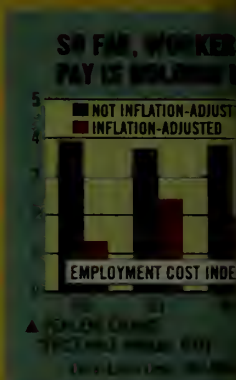
Workers, too, are seeing a plus from strong produc-

tivity growth. With unit costs down, companies have to squeeze pay as much as they have in periods of weakness. The Labor Dept.'s employment index, a gauge of hourly wages and benefits, increased at a 4% yearly clip in the second quarter.

Wages and salaries alone climbed 3.6% from a year ago, and real take-home pay, adjusted for inflation, is up 2.5%. Amid declining inflation, consumers who are on the job are enjoying a boost in purchasing power (chart). And now, labor markets are slowly starting to improve.

This summer's stock market drop will almost certainly cause households to save more of their income. However, the new data show that real aftertax income in the second quarter were up a strong 5% from a year ago, thanks to tax breaks, low inflation, and productivity. That means consumers have the wherewithal to save more and spend more at the same time.

To be sure, government rewrites of history are maddening for anyone trying to divine the path of the economy. But on balance, Commerce's latest statistics are more reassuring than many past revisions suggest that the recovery is on solid ground.



BRITAIN

TIME TO HEAD OFF INFLATION

The British economy is starting to fire on all cylinders as the manufacturing sector slowly recovers. But uncertainty in the financial markets and tame inflation will make any decision by the Bank of England to hike interest rates especially tricky.

The first look at second-quarter real gross domestic product showed the economy grew by 0.9% (chart) after posting two straight quarterly gains of just 0.1%. It is the biggest quarterly rise since the last quarter of 1999.

The government reported that service-sector output, the primary engine of growth for more than a year, rose by 0.6% from the first quarter but continued to slow on

a yearly basis. The World Cup and the Queen's Golden Jubilee hurt retail sales in June, but an ebullient housing market should keep consumer spending healthy.

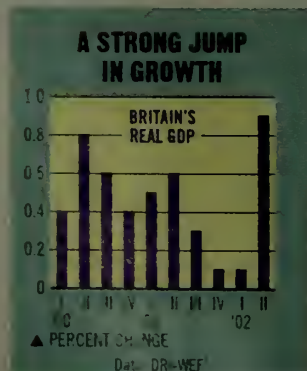
More important, though, industrial output was estimated to have grown strongly, with the manufacturing sector breaking its string of five consecutive quarters of declining output. Through May, industrial production is up 1.8% from the first quarter. Tech equipment is showing its first rise since the end of 2000, and production of durable goods is up 4.3% as well.

However, the FTSE 100-stock index is among several key indexes around the globe that is down

more than 20% this year. The plunge pushed consumer confidence to a seven-month low in July, even though consumers' outlook of their own finances improved. Also, the Confederation of British Industry's survey of industrial confidence showed surprising weakness in the third quarter.

Amid rough financial waters and inflation below its 2.5% target, the BOE is under little pressure to raise interest rates. But the economy is expected to grow better than 3% next year, vs. forecasts just shy of 2% for 2001. Such a healthy pace has the BOE projecting a pickup in inflation next year. With all sectors of the economy now growing and with a big boost in government spending on the way, the BOE is almost certain to raise rates before year's end.

By James Mehring in New York





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THE ECONOMY

BIG BOOM, WEAK PROFITS

Revised figures tell a new story about the past three years

Trustworthy numbers are hard to come by these days. Corporations such as AOL Time Warner, Qwest Communications, and WorldCom are under investigation for accounting problems. The reputation of the accounting profession is in shambles. And investigators in Congress and the New York State Attorney General's office have turned up e-mails confirming the long-held suspicion that analysts are pressured to write favorable reports about the companies they follow.

The one beacon of honesty left seems to be the government statistical agencies—and that's what makes the latest report from the Bureau of Economic Analysis so important. The gross domestic product report, released on July 31, showed that last year's downturn was deeper and longer than first believed. The economy shrank for the first three quarters of the year, rather than the single quarter that the numbers originally showed. That removes any

doubt that the U.S. experienced a true recession in 2001. Moreover, the recovery so far in 2002 has been weaker than expected. First-quarter GDP growth, first thought to be 6.1%, has been revised down to 5.0%, while the second quarter clocked in at only 1.1%, less than half the 2.3% economists had expected.

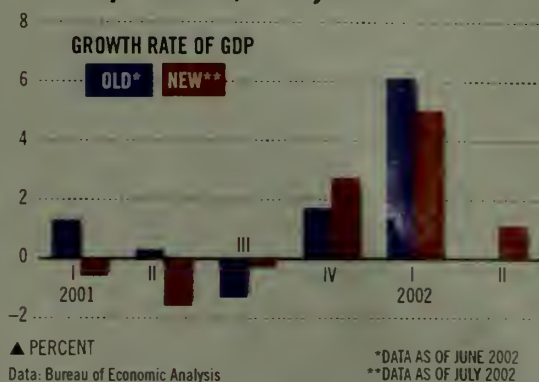
But more importantly, the report revises the economic data for 1999, 2000, and 2001, giving a far clearer sense of what really happened during the New Economy boom and bust. The good news is that despite the downward revisions, the productivity gains of the New Economy were real. Since 1995, productivity rose at a 2.5% annual pace, according to *BusinessWeek's* analysis of the BEA revisions. These numbers might change a bit when the Bureau of Labor Statistics releases its official productivity stats on Aug. 9. While slightly lower than the previous 2.6% rate, that's still a big jump over the 1.5% rate that prevailed from 1980 to 1995.

The bad news: Corporate profits much weaker than first believed. They've been revised down a total of \$143 billion, or 6%, for the three years from 1999 to 2001. While the revisions were concentrated in telecom, utilities, and business services, the problem went well beyond a few bad apples such as Enron Corp. and WorldCom Inc. Profits, rather than peaking in 2000 as everyone thought, actually hit their high point in the third quarter of 1997, and have been bumping lower since, especially in the financial sector. Instead of going towards profits, the benefits of fast productivity growth flowed out the door to workers and managers as higher wages and lucrative stock options.

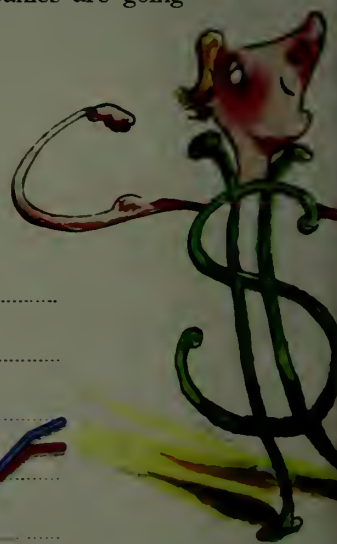
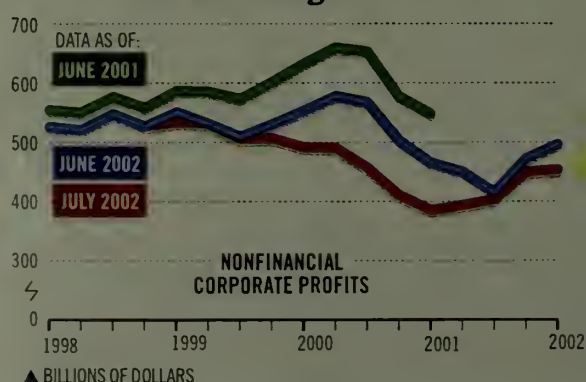
That means the stock market was even more irrationally exuberant in 2000 than anyone realized, skidding in value even as profits tumbled. This has big implications for the future. The new data from the BEA suggests that companies are going

WHAT THE NEW NUMBERS MEAN

Yes, there was a recession last year, as GDP declined in three quarters, not just one...



...And profits weren't as good during the boom as we thought...





to have to go through a prolonged period of rebuilding earnings to make up for the deep profit decline. In a world where demand is weak and it's tough to raise prices, that can only mean one thing: continued intense pressure on companies to hold down labor costs by laying off workers, reducing wage increases, and restricting the use of stock options. Indeed, companies such as Avaya, Provident Financial, and Alcoa have announced job cuts in recent weeks.

In 2000, the notion that Corporate America was in the midst of a profits recession would have seemed like heresy. Companies were reporting respectable increases in earnings per share, with the *BusinessWeek* profits scoreboard showing a 17% gain in the second quarter of 2000 over a year earlier. Federal Reserve Chairman Alan Greenspan lauded the profit performance of U.S. corporations. Even the government's initial estimate pegged corporate profits at a record \$964 billion in the second quarter of 2000, a rise of 15% over a year earlier. That made the sharp rise in stocks at the time seem at least plausible, if not fully rational.

But over time, the government statisticians refined their profit estimates, mainly using information from tax returns submitted to the Internal Revenue Service. The IRS data has several advantages. First, manipulating tax return data is harder than distorting earnings statements, since there is no such thing as a pro forma tax return. Second, the tax data for profits, unlike the financial reports for investors, treat the cost of exercised stock options as an expense. Finally, tax return data includes all companies, from money-losing start-

**...But business
productivity held up
surprisingly well**

Nonfarm annual productivity growth

1980-1995	1.5%
1995-2002 (OLD)*	2.6%
1995-2002 (NEW)*	2.5%

* Estimated using BLS and BEA data, second quarter of 1995 to second quarter of 2002

Data: Bureau of Economic Analysis; Bureau of Labor Statistics; *BusinessWeek*

ups to the biggest multinationals.

With each successive revision, corporate profits have dropped. The declines for nonfinancial corporations were especially dramatic. In March, 2001, the BEA originally reported profits for 2000 of \$631 billion. Then in June, it revised the number down to \$550 billion. The latest release shows only \$462 billion, a number well below the overall profits figure for the preceding several years. Profits for 2000 now appear to have fallen 11% below the revised 1999 total of \$518 billion, and 17% below overall 1997 profits of \$556 billion—the year they peaked.

It may well be that the bad news is not over, either for 2000 or 2001. As companies such as WorldCom officially restate their profits, they will refile back tax returns, which will eventually

show up in the government figures. And the BEA's profit numbers for 2001 are vulnerable to further revisions as more complete tax data become available.

The profits revisions show just how weak many companies became in recent years. But how did so many fall into such bad shape? A lot of startups ran up big losses during the tech frenzy of 1999 and 2000. Not surprisingly, the industries with the biggest downward revisions in profits were business services—most of the dot-com startups—and new telecoms. Webvan had \$438 million in operating losses in 2000, PSINet lost \$735 million, and Global Crossing lost a whopping \$1.4 billion. Remember Pets.com? It lost nearly \$100 million in 2000 before closing down.

Moreover, the BEA also subtracts the

value of exercised stock options, can be enormous. For example, Kenneth Lay and Jeffrey Skilling of Enron exercised stock options worth \$185 million in 2000—an expense that shows up as a hole in the government's overall profit but not in reported earnings. In total, top executives took home at least \$1 billion from exercised stock options and other long-term compensation in 2000, alone, and perhaps much more.

Finally, companies were simply paying a lot of money to managers and workers. Of course, part of this was in the form of outsized compensation packages executives got. But the biggest cost was the rising outlay for ordinary workers. During the boom years, companies were hiring people at a frantic pace and paying them more and more. Surpris-

CONSUMER CREDIT: A CRUNCH MAY BE COMING

Thank Amy Bell for helping keep the U.S. economy afloat. Bell, a 27-year-old benefits manager in Atlanta, bought a studio condominium with no money down, leased a Volkswagen Passat, and spent \$2,300 on a set of living room furniture—all in the past six months. "I have been going a bit crazy with the spending," she says.

That's for sure. Bell and plenty of other people are piling up huge debts. The amount that Americans owe on loans for houses, cars, credit cards, and other purchases adds up to nearly 100% of their annual income after taxes. That's up from 75% in 1992, after the last recession ended.

Even if consumers are willing to take on more debt, lenders—and more important, the investors who buy many of the loans they securitize—may soon decide that enough is enough. If the credit crunch now squeezing business starts to hit consumers, whose spending accounts for two-thirds of gross domestic product, the U.S. economy could wind up in a world of trouble.

For now, a consumer credit crunch is hardly inevitable. Unlike businesses, consumers still have an easy time raising money. When they max out one credit card, it's a cinch to sign up for another. Outstanding consumer credit, most of it from credit cards and auto loans, rose 5.7% in the 12 months ended in May. And the amount of home-mortgage and home-equity loan debt outstanding keeps rising, too. It's up 10.5% for the year ended in March.

Banks have been eager to expand consumer lending, because profits from their commercial loan, brokerage, and investment banking departments have tanked. Income at Citigroup's consumer businesses, for instance, grew 25%, to \$2 billion, in the second quarter.

For now, the combination of rising debt and falling interest rates continues to fuel consumer spending. In the past two months, mortgage refinancing has given consumers a further \$40 billion to \$50 billion to spend, estimates Bank One economist Diane C. Swonk. In nearly two-thirds of recent refinancings of loans owned by Freddie Mac Corp., people took out bigger loans than the ones they paid off, freeing up cash for more spending. And despite being burned repeatedly, lenders still increase loans to subprime borrowers. Swonk thinks that's a big factor in strong auto sales.

But there are signs a consumer credit crunch could be in the offing. Delinquencies on non-mortgage consumer debt reached 1.86% of debts at the end of 2001, up a third from 1.4% a year earlier and the highest in a decade, ac-

cording to the Consumer Bankers Association. In the past year, Provident Financial, Metris, and NextCard have been crushed by bad debts. The Federal Reserve's estimate of the liquidation of NextCard will cost taxpayers up to \$400 million.

As a result, the government is stepping up oversight, which in turn



cut the supply of credit to some consumers. So far, attention is mainly on subprime lenders. "We want to focus on the higher risks," says Gibbons, deputy comptroller at the Office of the Comptroller of the Currency. On July 22, bank regulators announced guidelines to prod credit-card issuers into increasing reserves and disclosing defaults promptly, after discovering many were pushing the limits

age increases continued even into recession. From 1997-2000, real wages rose by 5%. And since the end of real wages have risen by another 11% told, from the first quarter of 2001 to the first quarter of 2002, compensation to workers and executives, including exercised stock options, rose 4 trillion. By comparison, corporate profits were flat.

The recession in New Economy profits explains why there was so much chicanery during the boom. Companies were under pressure for low earnings growth, even while real profits were declining. The weakness also explains the deviation in the stock market over the couple of years. In effect, stock prices had been soaring for three years, 1997-2000, while earnings had been falling. As a result, it took a long bear market to get stock

EARNINGS HAIRCUT

As profits for 1999, 2000, and 2001 have been revised downward, these sectors took the biggest total hit:

IN BILLIONS OF DOLLARS	
FINANCIAL COMPANIES	-2.1
AUTOS AND EQUIPMENT	-14.8
RETAIL TRADE	-16.3
UTILITIES	-24.5
COMMUNICATIONS	-32.3
BUSINESS SERVICES AND OTHER	-57.3

Data: Bureau of Economic Analysis

values back into line with profits again.

But the readjustment won't likely stop there. Profits at nonfinancial corporations are still only 8% of corporate output, way below the 11% in 1998. To get profit margins back up to a normal

level, companies will have to hold labor compensation flat for at least another year. That likely means cutbacks in health benefits, smaller wage increases, and fewer jobs.

Still, there is no sign in the revision that the central achievement of the New Economy—faster productivity growth—is disappearing. Indeed, the latest numbers strengthen the case that output per worker is still rising at a full percentage point faster than it did in the previous 15 years.

But the new numbers also show that productivity growth is not a magic elixir. Just as the U.S. economy experienced high productivity growth with flat or falling profits, the pendulum may swing back the other way, and we may be entering a period of high productivity growth combined with a weak labor market.

By Michael J. Mandel in New York

Some lenders may drop out of the market, predicts Reilly Tierney of investment bank Fox-Pitt, Kelcey, New York.

But the concerns could also begin to gather-grade credits in coming months. That's the way nearly every credit bubble ends: from the bottom up. The quantity of debt is so large that even without regulators' intervention, analysts warn that any of a number of factors could spook lenders:

modest decline would leave people owing more than their house is worth. That would cool cash-out refinancings, which have propped up consumer spending. And it would frighten lenders, who would lose the ability to make themselves whole through a repossession. "It could bring to the fore a great deal of hidden credit risk," says Stuart A. Feldstein, president of SMR Research Corp. in Hackettstown, N.J. "In mortgage lending, the [profit] spreads are so thin that there's no room for big losses."

An increase in interest rates by the Federal Reserve could be the trigger for a fall in home prices. Right now, a Fed rate hike remains unlikely. But if the stock market keeps rebounding and the recovery continues, it will strengthen Fed hawks who argue that low rates and excessive money creation are inflating new bubbles in the economy.

For lenders, the problem is that consumers are dangerously dependent on today's superlow rates. When rates fall, the cost of servicing debt should fall, too. Yet the Federal Reserve says that household debt-service payments were more than 14% of disposable income in the first quarter, near the highest level in 22 years. If rates go higher, the burden of debt service will increase. Mortgage Bankers Assn. economist Phil

Colling says that approximately 30% of outstanding mortgage debt has adjustable rates. And about 40% of non-real-estate consumer debt is revolving credit, much of which has adjustable rates. A credit crunch could set in if a rate rise triggers a wave of defaults by holders of adjustable mortgages and revolving debt.

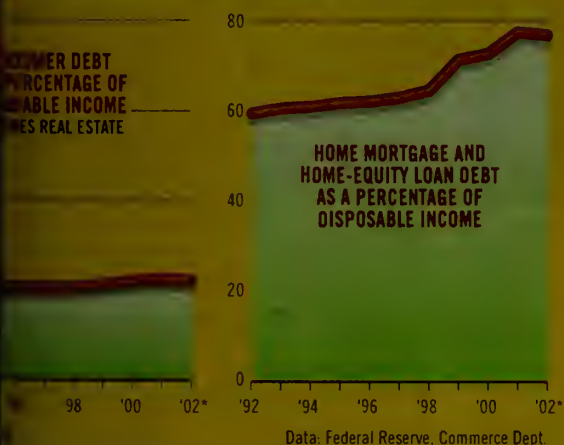
Aside from rising rates, the other nightmare for lenders would be a lull in the job market. Thanks in part to tax cuts, disposable income after inflation rose 5% in the year ended in the second quarter. That helped hold down the debt-to-income ratio. But lenders would be more reluctant to extend credit if the unemployment rate spikes or real incomes slow their rise, because they would be worried about getting paid back. And rates are already so low that the Federal Reserve couldn't easily use further rate cuts to lure consumer lenders back into extending credit.

A final wild card is the new bankruptcy bill, which will take effect six months after President Bush signs it into law. Feldstein of SMR Research says some shaky credit-card issuers could be driven under if many of their cardholders file at once to obtain protection from creditors under the old, more lenient law. That, in turn, could disrupt the flow of fresh credit.

The credit crunch on business has been painful. But for Amy Bell and the home buyers, car shoppers and mall walkers like her across the country, a credit crunch would be a real killer.

By Peter Coy and Heather Timmons in New York, with Brian Grow in Atlanta, David Welch in Detroit, and Mike McNamee in Washington

REACHING THE BREAKING POINT?



house prices, a rise in interest rates, or a softening of the job market would push up unemployment and wage gains.

If lenders would tighten up in housing prices soften. That's a possibility, given what Freddie estimates is a 37% average decline in house prices in the past five years. If rates today are purchased with interest rates of 5% or less, so even a

GOVERNMENT

ANY REFORM IDEA IN A STORM?

Lawmakers eager to appease voters are trying all kinds of stuff

Get ready for Act II of *Law and Order: Corporate Crime Unit*, the gritty drama that Washington lawmakers can't get enough of. Even as President Bush on July 30 signed a sweeping reform bill to shake up the accounting industry and corporate boards, Congress was weighing a fresh batch of cleanup legislation meant to appease angry voters. In store for the fall political season: new safeguards for 401(k) pension plans, protection for investors burned by the market meltdown, and a clampdown on corporate tax avoidance.

What exactly will be enacted is anyone's guess. Much depends on the earful constituents give lawmakers during summer recess. And if another corporate scandal erupts, lawmakers will be falling over themselves to act tough. But, in truth, some of the ideas being floated in Washington seem too half-baked to take seriously. Here, for better or worse, is a preview of the upcoming Second Wave of Reform:

PENSION REFORM The House has passed a relatively weak bill that lets workers sell company shares in 401(k) plans three years after acquiring them and allows plan managers to offer investment advice to workers—a move that could open the door to conflicts of interest. The Senate is likely to combine competing proposals to permit speedier diversification and encourage companies to provide independent investment advice. Outlook: a modest compromise bill that

hews more closely to the Senate version.

Republicans and some Democrats also want to loosen the rule that requires 401(k) participants to begin withdrawing money from their accounts at age 70½. Trouble is, raising the age to say, 75, would cost the Treasury billions annually because the money would remain in nontaxable accounts longer. Besides, the



“We need to do more to strip corrupt kingpins of their ill-gotten gains. We’re taking the mansion. We’re draining the accounts. And we’re coming after the yacht”

— TOM DELAY

change would only benefit the well-off, who don't need to draw on their funds. Outlook: Despite the problems, bipartisan support gives this a fighting chance.

TAX HAVENS The Senate Finance Committee on June 18 approved a bill that would curb the ability of companies to move their headquarters to countries that levy few or no business taxes. In the wake of September 11, Democrats and Republicans have blasted as unpatriotic the efforts of Stanley Works, Ingersoll-Rand, and Cooper Industries to relocate to Bermuda and other tax havens. The measure will like-

ly face a vote this fall. In the though, a three-year moratorium bogged down by opposition to a provision to end trade subsidies. Outlook: A once-reluctant Congress likely to at least temporarily cut corporate-tax escape route.

TAX BREAKS To help investors have suffered big market losses, Republicans are mulling increasing the amount of capital losses that investors can use to reduce their income taxes. They would raise the limit from \$3,000 to as much as \$20,000. That, too, would increase the deficit without helping the vast majority of stock-owning households whose equity holdings are largely in pension plans, which don't incur capital gains taxes. Even Senate Republicans are skeptical. Outlook: unlikely.

DAMAGE CONTROL Bush signs a sweeping corporate-fraud bill

RESTITUTION Representative Richard (R-La.), wants to strip all the money collected by the Securities and Exchange Commission, the Justice Dept. and the FBI from securities fraud, as well as disgorgements by corporate executives of ill-gotten gains, into a fund to help defraud victims. House Majority Leader Tom DeLay (R-Texas) embraced the idea.

need to do more to strip corrupt kingpins of their ill-gotten gains,” says Tom DeLay. “We’re taking the mansion. We’re draining the accounts. And we’re coming after the yacht.” But key details have not been worked out, such as the logistics of setting up such a fund, identifying the defrauded investors, and giving them their pro rata restitution. Outlook: long shot, given the lack of time to work out details and build bipartisan support.

If you total it all up, what Congress is contemplating could be a costly list to appease angry investors. Add to the growing budget deficit seems politically fraught. But if another big company melts down in a heap of accounting misdeeds, you can bet Congress will be showcasing the Second Wave.

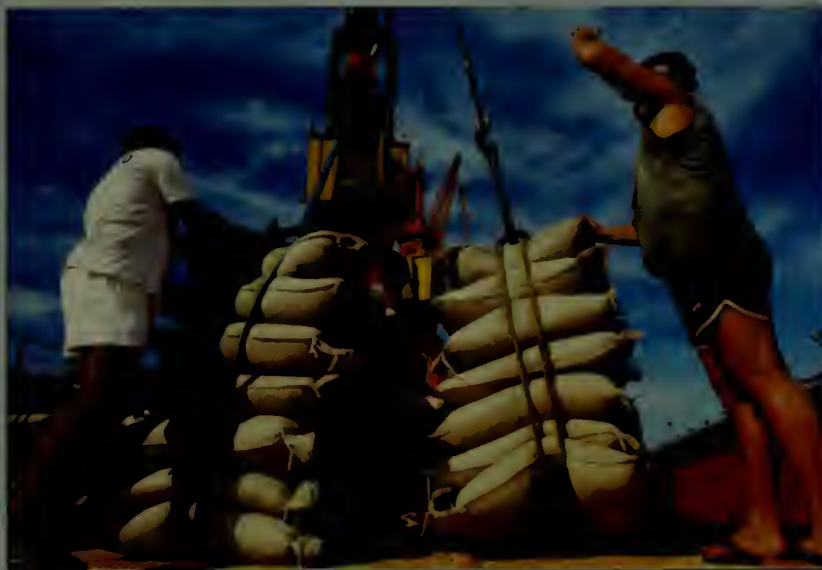
By Amy Belton
in Washington

COMMENTARY

By Paula Dwyer

FAST-TRACK AUTHORITY: DON'T UNDERESTIMATE ITS CLOUT

With Congress on the cusp of granting the President a freer hand negotiating trade deals, George W. Bush is wasting no time. Armed with the power to ink trade pacts that Congress can ratify or reject, but not amend, Bush hopes to complete long-stalled talks with Chile and Singapore. Next, he'll go to clinch deals with Australia, Central America, and five southern African nations. And in pursuit of the two biggest goals, Bush hopes to push negotiations to establish a free-trade zone for the entire Western Hemisphere, as well as ongoing global trade talks at the World Trade Organization. It's a hefty to-do list, and Administration critics charge that Bush's tilt toward protectionism will make it tough to complete. After all, negotiators from across the Atlantic south of the border question whether the U.S., which recently imposed steel tariffs and approved massive new farm subsidies, is willing to open its markets further. "You can't have free trade and apply trade restrictions at the same time," says Alo Thorne, J.P. Morgan Chase & Co.'s chief Latin America economist. Yet even if the President only ticks a few items on his list, he could emerge as a big winner in the global trade sweepstakes. "Steel tariffs and ag subsidies were a detour," says Robert D. Hormats, managing director of Goldman Sachs International. "President Clinton couldn't get fast-track, but President Bush is out to. This gives him a leadership the U.S. hasn't had since 1994" when the last fast-track law lapsed.



SWEETER DEALS? Sugar exporter Brazil may want to negotiate

One reason Bush may surprise his critics is that the European Union, which can't seem to agree with the U.S. on anything these days, sees fast-track approval as a positive sign of U.S. intentions. "The credibility of the U.S. has gone up," says Steven Everts, director of the transatlantic program for the Center for European Reform, an independent think tank. "Trade liberalization stands and falls on agreement between the U.S. and Europe."

For Bush to succeed, he'll have to bring two of the most important players, Brazil and China, back to the negotiating table. While Bush was busy bartering for votes to win a fast-track deal, Brazil lost interest in talks to establish a Free Trade Area of the Americas (FTAA). It's also feeling stung by U.S. limits on imports of Brazil's orange juice, sugar, and other farm products. China, too, is unhappy with the U.S.'s protectionist moves. With Beijing competing against Japan for influence in the region, its priority is to set up its own regional pact, an Asian Free Trade Area with 10 other Southeast Asian nations.

Yet, despite the increasingly anti-

U.S. tone permeating Latin America and China these days, many business and political leaders in those regions know that increased exports are their best hope for emerging from the current economic slump. Sooner or later, says Calman J. Cohen, president of the industry-backed Emergency Committee for American Trade, other countries will calculate that it's in their own self-interest to liberalize trade. Horácio Piva, president of the São

Paulo State Federation of Industries, agrees: "We get disheartened because of farm bills and measures against our steel, but we could make more effort in the talks over the FTAA. [It] has a future."

Indeed, if Bush uses the fast-track process to quickly complete a free-trade deal with Chile, and finalizes another pending agreement with a group consisting of Peru, Bolivia, Ecuador, Colombia, and Venezuela, then Brazil could find itself out in the cold. Negotiations over U.S. antidumping laws, which have been a thorn in Brazil's side, could also prove fruitful. "Fast track could be an extraordinary vehicle for reengaging Latin America," says Peter Hakim, president of the Inter-American Dialogue, a Washington think tank. Adds William Lane, Washington lobbyist for Caterpillar Inc.: "The bottom line is, the Administration won the game and few people are going to look back." That will only be true, however, if Bush pushes hard to make the most of his new fast-track powers.

*With Geri Smith in Mexico City,
Julie Forster in Chicago, and
Andy Reinhardt in Paris*

WHAT NEXT, R. PRESIDENT?

Bush soon may have a freer hand negotiating trade deals. Here's a to-do list:

- Complete stalled free-trade talks with Singapore and Chile, both of which began under President Clinton.

OUTLOOK:

Could be finished by yearend

- Open talks with regions that have expressed interest in a free-trade deal. Among them: five southern African and five Central American nations.

OUTLOOK:

Very favorable

- Reinvigorate talks to establish a Free Trade Area of the Americas ranging from Canada to the tip of Latin America.

OUTLOOK:

Will require a second Bush term to complete

- Pursue global talks begun last November in the Doha Round of the World Trade Organization.

OUTLOOK:

Likely only with a second Bush term

EXECUTIVE SUITE

MOTOROLA: NEW NO. 2, SAME GAME PLAN

Can COO Zafirovski keep the restructuring on track?

On the morning of July 25, Edward D. Breen went to Motorola Inc. CEO Christopher B. Galvin with crushing news: Just six months into his hard-charging tenure as the company's chief operating officer, Breen was leaving to run troubled conglomerate Tyco International Ltd. Breen's departure stunned Galvin and the board of directors, who were "frankly very annoyed," says board member Nicholas Negroponte.

That didn't stop the board and management from acting decisively, however. Within hours of Breen's departure, Galvin tapped Mike S. Zafirovski, formerly chief of the company's cellular

business, as Motorola's new COO. The appointment seemed to steady investors, who initially rushed for the exits, fearing that Motorola's ongoing restructuring would run off the rails without Breen. "Mike's a great leader," says Motorola board member Samuel C. Scott III. "He was an obvious candidate."

With the transition done, Motorola watchers were left wondering why Breen bolted. Now knee-deep in Tyco's beleaguered business, he didn't return phone calls to explain. But given his ambitions, it isn't hard to understand. Breen was frustrated, says a wireless executive, because he had to run to

Galvin "every time he wanted to get something done." Besides, Breen clearly saw the Tyco CEO job as a challenge he couldn't pass up (page 37).

In fact, his departure shouldn't have surprised Galvin at all. He knew Breen wanted to be CEO. And with Galvin under heavy pressure to return the company to profitability, investors were calling for him to step down within two years. But thanks in large part to Breen's successful cost-cutting, Galvin is now less vulnerable. After all, Motorola reported operating income of \$193 million in the second

quarter, up from a loss of \$264 million in the same period in 2001. It became clear to Breen that a more secure position wasn't going anywhere anytime soon. "He's the king," says a senior executive close to Motorola. "And he's not about to be knocked off the throne."

With Galvin at the top, Motorola needs a solid No. 2. Zafirovski—around Motorola as Mike Z—faces formidable hurdles as he takes over day-to-day operations of the 100,000-employee, \$30 billion company. The first order of business: turn a profit this year. Before Breen left, he promised earnings of 14¢ a share. Zafirovski will have to meet that target while halting a string of 14 straight one-time charges that hurt operating performance. He also must fix a \$6.4 billion wireless infrastructure business amid a weak market. Speed on switching gear that zaps phone service from user to user will likely edge profit just 2.25% to \$53.5 billion this year, says analyst In-Stat/MDR. Finally, Zafirovski must make the chip unit profitable by mid-2003. "He'll have challenges because he hasn't run those other businesses," says Jane Zweig, CEO of wireless consultant Herschel Shostek Associates Ltd.

Still, Mike Z has proved himself an adept manager. Since taking over Motorola's cell-phone division in June, 2000, the former Gen-



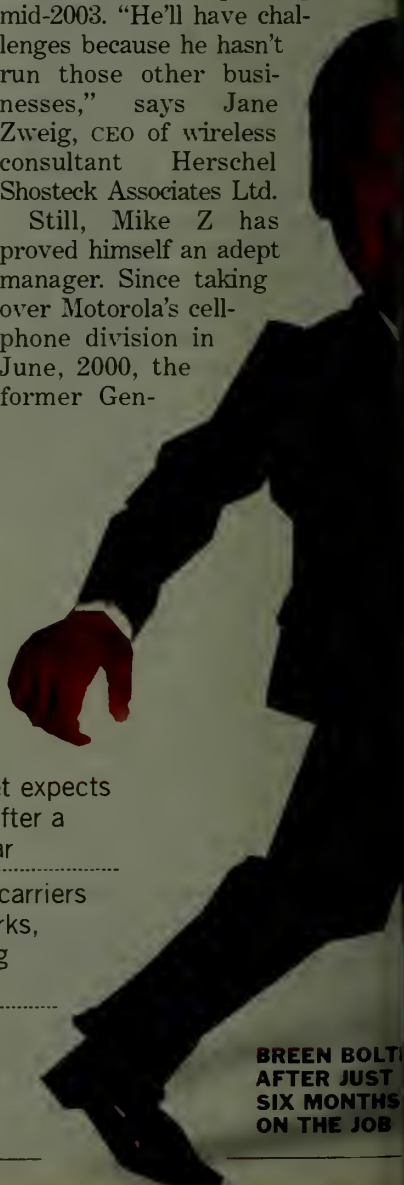
GALVIN'S SELECTION OF ZAFIROVSKI SEEMS TO HAVE CALMED INVESTORS

MIKE Z'S CHALLENGES

MAKE MONEY Wall Street expects Motorola to turn a profit after a \$697 million loss last year

REPAIR WIRELESS With carriers cutting spending on networks, Zafirovski has to fix this dog or dump it

FIX CHIPS He must complete the restructuring of the \$5 billion money loser



BREEN BOLTS AFTER JUST SIX MONTHS ON THE JOB

Electric Co. exec has almost managed to turn around the \$10.5 billion loss. In the second quarter, it made \$1 billion on sales of \$2.6 billion and increased its market share the past two years from under 13% to more than 18% today. When Motorola was facing the shuttering of a key type of technology, Zafirovski sensed it was in demand by customers and boost-

ed output from zero to some 6 million this year. "He was able to turn our ship to meet customer needs," says cellphone general manager Ron Garriques.

It will take Zafirovski a while to prove his merit as COO. But if he helps get Motorola humming by the middle of next year, Galvin could again be in the same predicament he faced with Breen. Success would make Zafirovski a

hot commodity, and he, too, could prove eager to run his own show. Galvin gets credit for bringing talented managers to Motorola, but "he should be open to moving aside," says Walter J. Casey, tech analyst of Banc One Investment Advisors, which owns Motorola shares. Unless he's flexible, Galvin could find himself stunned once again.

By Roger O. Crockett in Chicago

COMMENTARY

By William C. Symonds

A TO-DO LIST FOR TYCO'S CEO

By the time Edward D. Breen took the reins as the new CEO of Tyco International Ltd., on July 1, he had already received what would be a hero's welcome on Wall Street. In the two trading days after his surprise announcement that he was resigning as president and COO of Motorola Inc. to head the troubled Bermuda conglomerate, Tyco's stock rose 53%, adding a neat \$9 billion to its market value.

But the honeymoon could be short-lived unless Breen, 46, uses his mandate to quickly embark on a deepening transformation of the \$36-billion giant. Breen's first priority will be to win back investors' trust, badly eroded by the previous management's aggressive accounting, indiscriminate acquisitions, strategic missteps, evasion of U.S. taxes, and disregard for minimal standards of corporate governance.

Beyond that, Breen will have to squeeze growth from a company engaged in a range of prosaic industrial businesses that, while profitable, are facing declining margins. Without

the rapid-fire dealmaking favored by Breen's predecessor, Dennis Kozlowski, Tyco can't report

the kind of blistering results of the past. Still, most analysts believe Tyco can earn some \$4 billion on sales of \$38 billion next year, a decent return for a cyclical industrial manufacturer. "A company like that should be worth 11 or 12 times earnings," or twice today's levels, argues Kevin McCloskey, a portfolio manager at Federated Investors Inc., which is keeping its stake of 5 million-plus shares.

Much depends on Breen's abilities as a manager and turnaround artist. His appointment was almost universally hailed. In a career that has included a stint as CEO and chairman of the cable-equipment maker General Instrument Corp., as well as the No. 2 job at Motorola, he has "an outstanding reputation as an excellent operating manager well-versed in restructuring and turnaround for manufacturing businesses," says Nicholas Heymann, an analyst at Prudential Financial.

Breen's first task will be to clean house, starting with the board. "The credibility of the old guard is gone," says David Dreman, chairman of investor Dreman Value Management LLC. The board remains packed with such veterans as former Tyco CEO John F. Fort, who helped groom Kozlowski, and former ADT Chairman

Michael Ashcroft, one of the first to discover the merits of a Bermuda base. Breen also needs a new executive team. The current crop is too closely linked with Kozlowski to effectively implement the radically different strategy Tyco needs today.

After more than two years of controversy over Tyco's accounting, Breen also needs to move quickly to

restore faith in its numbers. Even now, Tyco is still trumpeting discredited pro-forma results and unusually generous measures of cash flow.

Breen should bring in respected outsiders to develop strict, conservative accounting procedures. Quickly resolving investigations by the Securities & Exchange Commission and other authorities is also essential.

Breen's final urgent priority is eliminating fears of a liquidity crunch. Despite rumors of impending bankruptcy, debt analyst Eric Ause of Fitch Ratings doesn't believe Tyco faces an immediate crisis, since it has over \$7 billion of cash. But even Tyco concedes it faces a \$1.5 billion shortfall in paying off \$12 billion-plus of debt coming due by the end of next year. And that assumes free cash flow of \$4 billion in the coming fiscal year, up from a projected \$2.5 billion this year. With margins at virtually all of Tyco's businesses under pressure, that won't be easy.

To raise cash and rebuild Tyco's balance sheet, Breen must move aggressively to pay down debt by cutting costs and sell some businesses. Even in today's market, "there'd be a number of buyers" for pieces of Tyco's highly competitive medical device companies, says Merrill Lynch & Co. analyst John G. Inch. Once Breen has weeded his portfolio, Dreman figures Tyco's industrial holdings should be able to generate earnings growth of 7% a year, equal to the long-run performance of the Standard & Poor's 500-stock index.

To be sure, Breen could be blindsided if ongoing investigations turn up deeper problems with Tyco's accounting—forcing a restatement and possibly sparking a liquidity crisis. Barring that, Tyco is hardly doomed. This is a company that can be saved.

Symonds is Boston bureau chief.

BREEN'S CHALLENGES

CLEAN HOUSE He must replace directors and execs with new talent

OVERHAUL THE BOOKS Tyco needs to be a model of conservative accounting

LOWER DEBT With about \$12 billion in debt due in 2003, Breen must also speed cost cuts and asset sales

AIRLINES

AN UNSCHEDULED LANDING FOR UNITED: BANKRUPTCY?

With cash dwindling fast, the carrier could face a crisis by fall



PRICEY LABOR: MECHANICS
RECENTLY GOT A 29% RAISE

Last fall, James E. Goodwin, then-chairman and CEO of UAL, lost his job. His big mistake: He bluntly warned that the airline would perish in 2002 unless it quickly stopped bleeding money. Eight months later, the company's planes are still flying, and UAL is sitting on a mountain of cash, thanks to a flurry of high-priced loans and frenzied cost-cutting. But as the peak summer travel season winds down, and as losses once again deepen, Goodwin looks more prophetic every day. Barring a government rescue, the world's No. 2 air carrier increasingly looks headed for bankruptcy by yearend.

Clearly, investors see the handwriting on the wall. Shares of UAL Corp., the parent company of United Airlines Inc., fetched \$34 each a year ago. Since then, they've fallen 83%—farther than shares of any major carrier except US Airways Group Inc. In July alone, UAL shares dropped 48%, to \$5.95, following a weak earnings report and a deteriorating outlook. UAL's market capitalization totals just \$332 million, vs. \$1.74 billion for archrival AMR Corp. Worse, its unsecured debt—which Standard & Poor's downgraded to a single-B rating in June—is trading at 25¢ on the dollar.

UAL execs, who confirm that the airline retained bankruptcy lawyers earlier

this year, won't discuss the possibility of a Chapter 11 filing. At first glance, bankruptcy hardly seems inevitable. UAL has amassed \$2.7 billion in reserves. It burns through less than \$1 million a day from its cash reserves to cover operating expenses, down from \$10 million a day in 2001's fourth quarter. The company has also applied for \$1.8 billion in new loans backed by the federal government. Moreover, it has just launched a marketing alliance with US Airways that promises to boost revenues.

But UAL's piggy bank may not hold out. The company must repay \$900 million in debt in the fourth quarter, plus \$150 million in early 2003. It needs \$500 million for essentials such as aircraft parts and at least \$250 million to cover its second-half operating losses. Add it all up, and UAL's reserves are on a course to fall below \$1 billion, the minimum amount that management says it needs to avoid a liquidity crunch by November.

As if that weren't bad enough, UAL has had little success with its biggest headache: rising labor costs. Al-

though outlays fell with the post-September 11 dismissal of 20,000 employees, or 20% of its payroll, they're on the upswing again. Earlier this year, a federal panel awarded United mechanics a 29% pay hike to make up for wages they took in 1994 as part of the employee takeover of the carrier. The arbitrator gave flight attendants a raise. And, in May, UAL pilots got a bump in pay. The raise came just as the rebound in business travel stalled in July.

Without federal loan guarantees, UAL execs concede a cash squeeze is certain. One cause of its shaky situation, the company is now a shut out of the capital markets, says Frederic F. F. UAL's chief financial officer. The International Association of Machinists even put a lien on UAL's headquarters to secure \$500 million in back pay the airline owes its men.

Problem is, management and labor are locked in a dangerous game of chicken that threatens UAL's chance of getting the government to go along. To qualify, UAL needs a one-year 10% pay

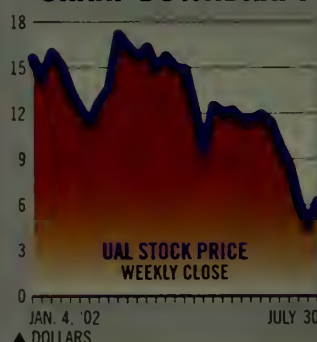
from its unions. So far, only the Air Pilots Assn. has acquiesced, and it can't scind the giveback if the other big unions don't chip in. That's not looking like it. Union leaders argue that management has exaggerated the airline's woes. Greg Davidowitch, president of the flight attendants council: "It's not wages that are causing the problem."

Even if the airline gets government backing for its loans, UAL won't be out of the woods until it can meet its obligations without more borrowing. With travel recovery stalling and the airline's labor woes unresolved, most industry observers don't see that opening until 2004 at the earliest.

If UAL goes bankrupt, the airline would probably be able to maintain operations and reorganize. But that's no sure thing. Brian M. Campbell of Campbell Aviation Group in Alexandria, Va., predicts that UAL could go the way of Pan Am, which filed for bankruptcy in 1991. If UAL's board had the guts, James Goodwin says seriously.

By Michael A. in Ch

SHARP DOWNDRAFT



Data: Bloomberg Financial Markets

REWD IVE, G BLUE

ng PwC Consulting gives
ull range of services

nce taking IBM's helm on Mar. 1, CEO Samuel J. Palmisano has spent most of his time pruning the tech's overgrown garden. IBM sold its y-losing hard-drive business and, second quarter, took a \$2.1 billion e to get rid of aging technologies inproductive workers in slowing asses. Now, it seems, Palmisano owed his clippers and begun plant-eds. In its biggest acquisition since g Lotus Development Corp. in IBM announced a deal on July 30 to ase PricewaterhouseCoopers' tech lting affiliate for \$3.5 billion in and stock.

old move—and one that prompted y favorable reaction among industry ers. It's easy to see why. The ac- ion meshes nicely with Big Blue's e-long transition from hardware r to services giant. Already, servic- e Big Blue's prime source of profits, ling 47% of its \$10.95 billion in pre- rofits last year. By buying PwC lting, IBM will bring under one roof package of services ranging from nd tech consulting to low-end sup- That will give it extra traction and against rivals such as Accenture and Hewlett-Packard Co. in a \$350 a global services market growing % annually.

good for PwC, too. Although an public offering was planned, PwC lting CEO Greg Brenneman says it



would have been unlikely to bring in more than \$2.5 billion, given current market conditions. And amid the crack-down on accounting practices, the serv- ices arm was losing clients fast because half of them also used PwC auditors. That helps explain why the deal was ne- gotiated in 10 days and why Brenneman says its partners are ecstatic about it. "They're very excited," he says. "There was not a single objection."

To be sure, there are major risks. The IT services market is scraping along the bottom right now amid weak de- mand, and the acquisition will almost certainly hurt in the short term. IBM Chief Financial Officer John Joyce says the buy will slash earnings in the fourth quarter by about 22% and continue to hurt profits in the first half of the year. If demand doesn't pick up as expected

CHUMP CHANGE:

Palmisano paid one-fifth of what HP was mulling

new employees. To sweeten the pot, PwC partners will get stock options priced near IBM's 52-week low, part of a retention pool that Brenneman values at up to \$700 million.

Most important, the acquisition brings IBM hundreds of big new customers and the high-margin consulting skills it had lacked. At the same time, PwC's expe- rience in such areas as financial services, government, and consumer products will provide IBM needed expertise to help companies use technology to solve more business problems. For example, IBM now will be better equipped to help its clients roll out software that lets them

next year, Palmisano's big gamble might not look so boffo. It just so happens that the area in which PwC specializes—high-end consulting and soft- ware installations—is the weakest link of the tech services mar- ket because few com- panies can afford such luxuries these days. Says Merrill Lynch & Co. tech analyst Steven Milunovich: "There's a risk that consulting doesn't come back as quickly."

Yet it seems that Palmisano has struck at an auspicious mo- ment. IBM is getting PwC Consulting for a song, considering that nearly two years ago HP mulled paying \$18 billion before aban- doning the acquisition.

Moreover, with the weak economy, IBM should have little trou- ble keeping its 30,000

new employees. To sweeten the pot, PwC partners will get stock options priced near IBM's 52-week low, part of a retention pool that Brenneman values at up to \$700 million.

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manage their sales, marketing, and financial operations. For PwC cus- tomers, the IBM hookup means they will get access to IBM's famed re- search labs, its outsourcing unit, and giant financing arm.

Like Microsoft Corp. and Dell Computer Corp., IBM is using the downturn and its financial muscle to squeeze rivals. Its Global Ser- vices unit is already the world's largest, with about 10% of the mar- ket. The deal could help the com- pany grab an extra 1% to 2% share. Much depends on a strong recovery in the tech services market. Other- wise, Palmisano will have to grab his clippers again.

By Spencer E. Ante, with Nanette Byrnes in New York

IBM: THE STRONG GET STRONGER

	IBM GLOBAL SERVICES	PRICEWATERHOUSECOOPERS CONSULTING
	150,000 employees in 160 countries	30,000 employees in 52 countries
ANCES	2001 pretax profits of \$5.2 billion on sales of \$35 billion	2001 net income of \$424 million on \$7.5 billion in sales
VICES	Big Blue is the world's biggest outsourcing provider, in which it takes over and manages entire computing systems for clients. It is also a leader in setting up complex computer systems. But analysts say its management-consulting unit lags rivals.	PwC is the No. 2 player in management consulting after Accenture. It helps half of the world's top 500 companies use computer technology to run their businesses more efficiently. It is also a leader in software integration, designing and installing systems that help a company run its sales, marketing, and financial operations.

EDITED BY MONICA ROMAN

GE BRINGS SOME THINGS TO LIGHT

CORPORATE REFORM GOT A significant boost on July 31, when General Electric joined the parade of companies pledging to expense stock options. Along with that move, which could ultimately trim 3¢ a share from annual earnings over the next few years, GE Chairman Jeffrey Immelt certified GE's financial reports two weeks ahead of the Securities & Exchange Commission's deadline. Immelt also announced that GE will require senior executives to hold shares for at least one year after exercising stock options and will restrict new board appointments to independent directors. While companies ranging from Computer Associates to Jones Apparel Group have recently announced their intent to expense options, few carry more weight than GE. The high-profile convert will put

additional pressure on other big companies to follow suit.

TRUE CONFESSIONS FROM CFOs

SHOULD INVESTORS BRACE themselves for a fresh spate of corporate-earnings restatements? Maybe, according to a new survey by *CFO* magazine. A survey of 141 CFOs of large public companies, to be published in the magazine's August issue, found that 17% said their CEOs had pressured them to misrepresent results in the past five years. And 5% succumbed, admitting that they had violated generally accepted accounting principles at least once in the past five years. But the post-Enron backlash may be stiffening financial execs' spines: 59% of the CFOs said they had disclosed more data to investors during the past three months.

QWEST ACCEPTS THE CHARGES

LOCAL PHONE GIANT QWEST Communications announced that it may have to restate as much as \$1.1 billion in revenues dating back to 1999. The changes relate to a number of transactions, including the controversial swapping of fiber-optic network space between carriers. Richard Notebaert, Qwest's new chairman and CEO, withdrew prior management's 2002 earnings projections, raising the possibility that the company might find itself in default when terms of its bank loans tighten later this year. Qwest has confirmed that it is under investigation by the SEC and the Justice Dept.

WARREN BUFFETT'S PIPELINE GROWS

THE PAIN IN THE ENERGY-trading industry appears to be Warren Buffett's gain.

HEADLINER: JOEL KLEIN

A QUICK STUDY GOES BACK TO SCHOOL

JOEL KLEIN MAY BE BEST known for prosecuting the government's case against Microsoft, but he wasn't versed in antitrust law when he came to the Justice Dept. in 1996. And few friends were surprised when the assistant U.S. attorney general left law in 2001 for business.

experience relevant to running a \$12 billion education colossus. What's more,

New York's schools famous for their assistance to char-

But Klein has a few things going for him. He's a quick study with a genuine love for the public school. "I'm going to put together a team that

brings together the requisite skill set that we need," he says.

And Klein's time at Justice might even come in handy. Some New Yorkers think a little trustbusting is exactly what this morose city needs.

By Dan Carlin
in Washington



Now the outgoing chairman of Bertelsmann Inc. is venturing even further afield. On July 29, Mayor Michael Bloomberg tapped him to head New York City's public school system. Other than attending and teaching classes at city schools, he has little expe-

Struggling to boost cash flow and improve its credit rating, energy trader Dynegy announced on July 29 that it was selling the prized Northern Natural Gas pipeline to MidAmerican Energy Holdings, a Buffett-controlled concern. MidAmerican will pay \$928 million and assume \$950 million of debt for Northern. Dynegy acquired the 16,600-mile interstate pipeline for \$1.5 billion, plus debt, as part of its failed effort to merge with Enron last year. The deal follows MidAmerican's March buy of another interstate pipeline, Kern River Gas Transmission, from troubled Williams.

to force investment banks fairly allocate IPO shares under the guidelines, which need SEC approval, investment banks can no longer charge investors inflated commissions for shares of an IPO, and can't shower executives with IPO shares for receiving investment banking work. other no-no: Bankers will no longer be able to insist investors prop up the price of a company by buying shares after its flotation condition for getting a piece of the IPO action.

ET CETERA...

- AOL Time Warner affirmed that the Justice Dept. is investigating its accounting.
- Vanguard, the low-fare airline, filed for bankruptcy and discontinued operations.
- Guidant will pay \$3 billion in stock for Cook Group, maker of drug-coated stents.

IPOs GET FAIRER AND SQUARER

INITIAL PUBLIC OFFERINGS will never be the same. On July 28, the National Association of Securities Dealers rolled out new rules designed

CLOSING BELL

TENANTS WANTED

Shares of Trizec Properties slipped 4.1%, to \$13.95, on July 31, after the real estate investment trust reported that funds from operations (FFO) fell 10.3% in the second quarter. The New York City-based REIT blamed lower occupancy rates and higher costs in some key national markets, and cut its forecast of FFO for the year by 9%.



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EDITED BY RICHARD S. DUNHAM

WHO'LL GET THE HOLD-YOUR-NOSE VOTE IN NEW JERSEY?

With voters up in arms about corrupt CEOs and abuse of power in high places, which is worse: a business executive who made a fortune from rising drug costs or a controversial career politician accused of taking gifts and wads of cash in return for favors?

This isn't a hypothetical matchup. In a race that could tip control of the Senate to Republicans, it's the choice New Jersey voters will face on Nov. 5. In the crosshairs: embattled Democratic incumbent Robert G. Torricelli. On July 30, the Torch was "severely admonished" by the Senate Select Committee on Ethics for "poor judgment" after a former fund-raiser claimed he had showered the senator with cash-filled envelopes and expensive gifts to win his help on business deals.

Torricelli has not been charged with a crime—although he apologized to the people of New Jersey for "lapses of judgment." Still, the publicity has jump-started the campaign of Torricelli's GOP challenger, Douglas R. Forrester, CEO of BeneCard Services Inc., which manages employee drug-benefit plans.

A Quinnipiac University poll in June had the Republican trailing Torricelli by just eight points. In a survey of 736 voters, only 44% favored the high-profile incumbent, while an impressive 36% backed the all-but-unknown Forrester. Polls also show Torricelli's approval rating slipping from a mediocre 41% in March to an alarming 35% in June.

With the moderate Torricelli firmly in the mainstream, Jersey political operatives blame his ills strictly on ethics woes. "First he says he received no improper gifts, then no illegal gifts, then he paid [fund-raiser David] Chang back for the gifts," says Forrester campaign manager Bill Pascoe. "It's going to boil down to what the definition of 'gift' is."

What's a running-scared senator to do? Go on the offensive.

With boardroom scandals gripping the nation, Torricelli use his \$6.1 million war chest to deflect attention from troubles by attacking Forrester's corporate ties. "He'll say that Doug Forrester is a CEO, all CEOs are suspect, then Doug Forrester is suspect," says Rutgers University political scientist Ross K. Baker.

In particular, Torricelli is zeroing in on the millions Forrester made from BeneCard—a middleman between makers and private and municipal health plans—while prescription-drug prices skyrocketed. "The way to make those obscene profits is by contributing to the artificially inflated costs of prescriptions," says Torricelli campaign manager Ken Snyder.

Torricelli is hammering away at a series of dividends—nearly \$8 million—that Forrester's closely held company paid him late last year. Just months before the CEO lent \$3.1 million to his own campaign. He is also trying to paint Forrester as sympathetic to big corporate interests—a particularly salient charge in a severely polluted state.

To fend off the assault, Forrester is labeling Torricelli a tax-hiking Democrat who caters to big campaign donors while ignoring the needs of his Garden State constituents. National Republican leaders are pitching in. Former New York Mayor Rudolph W. Giuliani

pledged \$700,000 for the state party on June 27. President Bush promised to headline an even bigger event.

Still, the deciding factor in November could boil down to who is lower on the totem pole, an ethically tainted politician or a greedy CEO? "The question is: Which negative is going to prevail?" says Rutgers' Baker. Torricelli is betting that anger over corporate crime will trump voter anger over everyday political sleaze.

By Lorraine Wright



TORRICELLI: *Admonished*

CAPITAL WRAPUP

GOP STOCK PLUNGES

► For months, George W. Bush's continuing popularity has cushioned Republican lawmakers from charges that they were in the bag for Corporate America. But now, with the President's job-approval rating dipping below 70% for the first time since September 11, GOP candidates are facing a fair amount of political fallout from the business scandals, stock market volatility, and voter fears of a double-dip recession.

For the first time in the Bush Presi-

dency, more voters pick the Democrats as the party best able to improve the economy, according to a July 26-28 Gallup Poll. And 65% say GOP pols are more beholden to large corporations than to ordinary people, while just 36% say that Dems are corporate pat-sies. One consequence: Democrats have taken a seven-point lead in Gallup's congressional match-up.

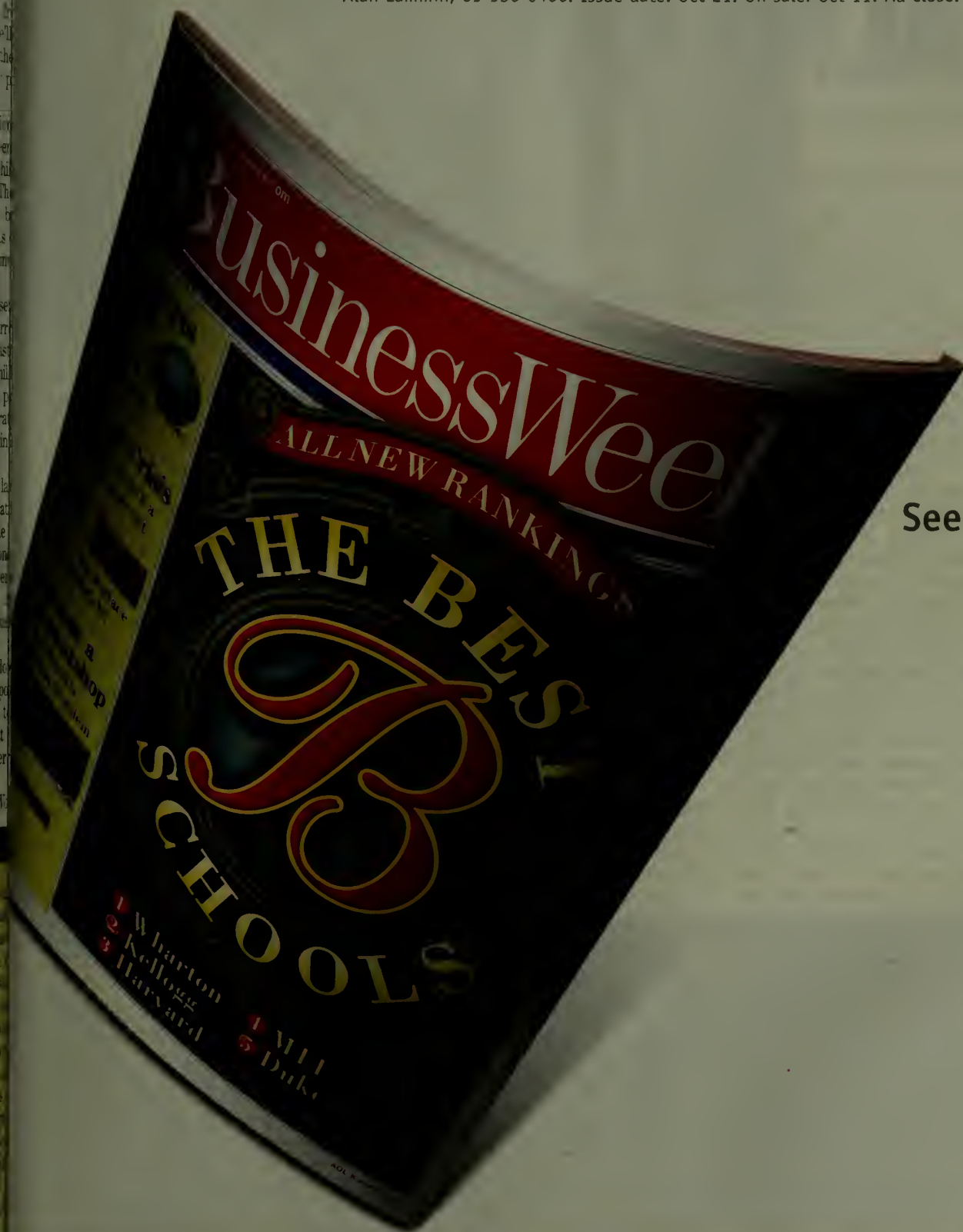
In past months, public support for the President had minimized the partisan damage from the continuing revelations of business misconduct. But now, with Bush and Vice-President

Dick Cheney under attack for their own past business dealings, the public is lumping Republicans together as defenders of boardroom privilege. A majority of Americans, 52%, say Bush hasn't done enough to deal with corporate scandals. And 45% say he should be doing more to right the economy. Another big shift: An increased number of voters now say Bush favors Business over ordinary folks. "Democrats are salivating," says media consultant Dane Strother. "I didn't think we had an issue until this."

By Richard S. Dunham

The A-list of B-schools.

Required reading for the current generation of business leaders and the next. To reach them, contact Geoff Dodge at 212-512-4611; London—Paul Maraviglia, 44-20-7330-9051; Singapore—Alan Lammin, 65-530-6400. Issue date: Oct 21. On sale: Oct 11. Ad close: Sep 23.



See inside

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HONG KONG

DISHONORED DEALMAKER

An inside look at the rise and fall of flamboyant tycoon James Ting

James Henry Ting—not long ago, that was a name to reckon with in the fast-paced business world of Hong Kong. Ting, like other ambitious young men who based their businesses in the former British colony, was a citizen of the world, an entrepreneur who constructed a universe of inter-related companies and finances from Toronto to Tokyo to New York.

Few, however, were as bold as Ting. Starting his career as a small-time electronics manufacturer in Canada in the 1980s, Ting built up a business under his holding company, Semi-Tech Group, that at its peak five years ago employed 100,000 workers in more than 120 countries and racked up almost \$5 billion in annual sales. Ting specialized in the rescue of well-known but tarnished brand names such as Singer Sewing Machine Co. of the U.S. and Sansui Electric Co., the Japanese consumer-electronics maker. As Ting's success grew, so did his hubris: He rode to one marketing meeting in Rome in a Ben Hur-style chariot.

Then, in a chain of failures that stunned employees, stockholders, and creditors, Ting's web of businesses un-

raveled, culminating in the largest corporate collapse in Hong Kong history. His main Hong Kong subsidiary, Akai Holdings Ltd., fell apart after recording an operating loss of \$150 million in 1999 and writing down \$1.75 billion of its assets. By early 2000, most of Ting's companies had stopped doing business, slid into bankruptcy, or been absorbed by other companies.

This spectacular fall left lenders and bondholders with unpaid debts of some \$2 billion. In Hong Kong alone, HSBC Bank has yet to recover some \$200 million, potentially its largest loan loss in more than 135 years in the enclave. And Ting? He sold his palatial \$5 million Hong Kong compound in June, 2000, and hasn't been seen in the city since meeting with creditors later that year. Sources say he is probably in mainland China, the place of his birth. Repeated efforts to reach him through his representatives have been unsuccessful.

The story of Ting gradually faded from the public memory of Hong Kong. Yet liquidators and creditors in Hong Kong, Canada, and the U.S. have kept combing through the wreckage, trying to figure out what happened. Now, these

efforts are yielding disturbing information about the goings-on in Ting's empire.

A report prepared for Hong Kong's Official Receiver's Office, which is charged with overseeing the liquidation of Akai Holdings, is raising questions about a series of deals. The authors of the report won't comment on the report itself says plenty: "The liquidators have substantial concerns in relation to the governance of Akai Holdings." The liquidators point to half a dozen suspicious transactions involving millions in cash and assets. The Commercial Crimes Bureau, a department of the Hong Kong police, is investigating Ting for possible fraud. The probe has set up a separate team to push the probe forward.

Meanwhile, thousands of miles away in New York, a civil lawsuit launched in November, 2001, by Semi-Tech Group's investors is gathering steam. The

HOUSE OF CORPORATE CARDS

James Ting once ran an empire with outlets in more than 120 countries. It's now in ruins.

AKAI HOLDINGS

Ting's main Hong Kong company moved from \$2.3 billion in assets in 1999 to bankruptcy a year later. It's still listed on the exchange, but trading is suspended.



SEMI-TECH

This Toronto company went into debt in 1993, then collapsed in 1999, leaving out thousands of investors and behind \$528 million in debt.



GONE MISSING
Ting was last
seen in Hong
Kong in 2000.
Authorities
suspect he
disappeared
into the
mainland.

**TING AT A 1997
PRESS CONFERENCE**

went public on the Toronto exchange in 1986.

Ting commuted regularly between Toronto, Hong Kong, and U.S. cities, doing deals that would make him a millionaire while still in his 30s. A big break came early on, when he was introduced by a onetime Ernst & Young Hong Kong accountant, Christopher Ho, to Macau gambling magnate Stanley Ho (no relation). Stanley Ho later became chairman of Semi-Tech. Neither Stanley nor Christopher Ho was available for comment.

Another important player was the government of China. After deft salesmanship by Ting, the Ministry of Electronics Industry inked a \$270 million contract with Ting to manufacture computers in Canada and Shenzhen. The deal helped

ends \$578 million from Ting, from directors of Semi-Tech, from Ting's investment bank, Bankers Trust, and his auditor, Ernst & Young. Plain-say that a series of transactions ended the terms under which the company issued \$300 million in bonds in 1995. The suit charges that Semi-Tech directors, including Ting, "conspired to deplete the assets of the debtors."

Countersuits in the suit also charge Ernst & Young and Bankers Trust with breach of fiduciary duty for failing to challenge deals between Semi-Tech and affiliated companies between 1995 and 1999. Ernst & Young is accused of fraud, conspiracy to defraud, negligent misrepresentation, and accounting malpractice.

Apparently, two branches of Ernst & Young came to different conclusions about their dealings with Ting. The firm continued to provide auditing and consulting services for Ting's Hong Kong companies for more than two years after its Toronto and New York offices dropped Semi-Tech as a client. Accord-

ing to the minutes of a Semi-Tech audit committee report quoted in the lawsuit, North American Ernst & Young dropped Semi-Tech because of a "breakdown in trust." In Hong Kong, meanwhile, police raided the accountancy's Hong Kong office in late June and seized Akai-related documents. Ernst & Young declines to comment, citing client privilege. Bankers Trust has filed a response to the complaint denying the allegations. It also declines to comment.

As for Ting, he has yet to be charged with anything. His sometime Hong Kong lawyer, Andrew Ng, offers a terse "no comment" on the affair, even when asked if he still represents Ting.

Born Ting Wei in Shanghai in 1951, Ting moved with his family to Hong Kong in 1958. After high school, he moved to Australia, married an Australian woman, then emigrated to Canada, where he studied engineering at the University of Toronto. In 1981, he started Semi-Tech Microelectronics, which

Ting land other mainland deals.

This was all a prelude to Ting's big act. In 1989, Semi-Tech made international news when it bought U.S.-based Singer Sewing Machine Co. By then, the venerable manufacturer was 138 years old and had also become a defense electronics company. Stanley Ho personally guaranteed \$100 million of the \$289 million purchase price.

The Singer acquisition allowed Ting to put into practice the global strategy that he had been plotting out for years: Stitch together a stable of companies and forge them into a big multinational. Singer gave Ting a sales and distribution network that reached into 120 countries. Ting aimed to transfer all manufacturing to China, where low labor costs would guarantee profits. The Singer purchase also provided Ting with credibility. "It was a milestone," says one longtime Ting business associate. After that, "he was known for his ability to do deals." In 1991, Ting took Singer public in a hot \$1.2 billion

SINGER

Drained of cash by Akai, the venerable sewing-machine maker was driven into bankruptcy. It's now out of Chapter 11 and operating under new management.



MEXICO: A Singer machine at work

OSINGS
DEC. '99
RS
Bloomberg Financial Markets

initial public offering on the New York Stock Exchange and then raised more cash in a secondary offering. He used his access to capital markets to fund a string of additional acquisitions, including Sansui Electric of Japan, Kong Wah Holdings of China—one of Asia's largest TV manufacturers—and G. M. Pfaff, a German industrial-sewing-machine maker.

As time passed, Ting's empire grew ever more labyrinthine. Akai Holdings alone consisted of more than 160 subsidiaries that ceaselessly shuffled assets and cash. As the Hong Kong liquidation investigation drily concludes, Akai's structure became "deliberately and unnecessarily complex."

Gradually, Ting and his companies grew dangerously overextended. In 1999, Singer filed for bankruptcy protection in New York. But it was more than a drop in sales that pushed it over the edge. The New York bankruptcy court uncovered a curious set of transactions between Singer and its related companies. In one, Singer paid \$157.5 million to Akai for shares in G. M. Pfaff—twice the value of Pfaff's publically traded shares. Pfaff then became a chronic money-loser, dragging down Singer. Singer also put down a \$50 million deposit to buy a Russian sewing machine factory. The deal never closed, but Akai, according to court documents, kept \$44 million of the money.



SECRET DEAL?

Stanley Ho's Grande Holdings mysteriously took charge of Akai assets in 1999

to Grande—without attestation to the Hong Kong Stock Exchange, created by the courts, or regulatory

The liquidators have professed themselves frustrated at the "complete lack of cooperation" on the part of Ting and his associates.

As the liquidators combed through the scattered records, they uncovered what they consider a pattern of suspicious transactions in which Ting's companies purportedly purchased assets—only to see their value written off shortly thereafter. In November, 1998, for example, Ting personally signed papers and wrote checks to buy, for \$38.5 million, 50% of a U.S. computer company named MicroMain Corp. A year later, in unaudited results for the year 2000, Akai took a loss for the entire amount. Later, MicroMain's managing director—who had been a director at another one of Ting's companies—claimed that no investment was ever made. Efforts to reach officials at Micro-

thorities. The deal was done through a four-page management agreement. Creditors say they learned of the change in corporate ownership only in September, 2000, when Grande presented 54 boxes of Akai records to the liquidators. In a brief telephone interview, Grande Holdings Executive Director Samuel K. Yuen denied that Grande had taken over Akai, saying that the management agreement had been "misunderstood." Whatever the case, Grande now does have control of key Akai assets. In fact, Ting, in conversations two years ago, asserted that Grande was in control of his empire.

The Ting case certainly raises uncomfortable questions for Hong Kong regulators.

QUESTION MARKS AT THE LIQUIDATION OF AKAI — A REPORT FOR HONG KONG'S RECEIVER'S OFFICE

These transactions came about after Akai had already taken \$1.1 billion out of Singer through stock and bond issues. The bankruptcy court found that the deals fatally weakened Singer.

Singer's slide was just a prelude to the final debacle—the collapse of Akai in late 1999 and the disappearance of its assets. At the start of 1999, audited statements showed Akai with \$2.3 billion in assets, including \$262 million in cash. By yearend, most of it was gone. The company has yet to provide an explanation; it never even issued an annual report for the fiscal year ended Jan. 31, 2000.

Stranger still, when court-appointed liquidators arrived on the scene a few months later, they found that Ting's "companies had no businesses, staff, or premises" and that most of the directors and officers of Akai had left Hong Kong.

Main were unsuccessful; the firm is apparently unrelated to a company of the same name in Austin, Tex.

What happened to the \$38.5 million? The liquidators reach no definite conclusions, but they list several options—including the possibility that the investment was never made, and that the money was instead diverted for some other purpose.

Not surprisingly, MicroMain Corp. is one of \$315 million in Akai deals that look funny to the liquidators—and to the Hong Kong police. Many involve similar outlays of cash and subsequent write-offs. The suspicion by creditors is that much of the money was siphoned off to overseas bank accounts.

Officers at one company may know how Ting's empire fell: Grande Holdings Ltd., founded by none other than Ting's old associates, billionaire Stanley Ho and Christopher Ho. In November, 1999, control of many of Akai's remaining assets mysteriously shifted

Neither the exchange, nor the Hong Kong Securities & Futures Commission, nor the city's Financial Services & Treasury Department appears to have undertaken a serious investigation of the scandal. drew Sheng, Hong Kong's top securities enforcement officer, says that his office has looked into the Akai collapse. "the matter is [now] in the hands of the police. We are providing all the assistance we can to both the police and the liquidators." The police agency is handling the criminal case said in a faxed statement that "the investigation is proceeding" and is being handled by the special fraud team.

There may be a plausible explanation for what caused Hong Kong's big bankruptcy. But until the truth is bare, the case of James Ting will cast a shadow over Hong Kong's financial community. That's too bad. These are light, not shadows, that a financial center needs.

By Matthew Miller and Mark L. Ford in Hong Kong, with Susan L. in New York

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GERMANY

ROUGH SHOALS FOR BANKS—AND GERMANY'S ECONOMY

With losses piling up, loans for new business are scarce

Like most bankers in Germany, Bernd Fahrholz is not given to panic or exaggeration. So it came as a shock on July 24 when the chief executive of Dresdner Bank, which holds \$500 billion in assets, declared that the country's financial institutions are in calamitous straits. "There is a crisis" in the economy, Fahrholz warned an audience of journalists, adding that "it is especially a banking crisis."

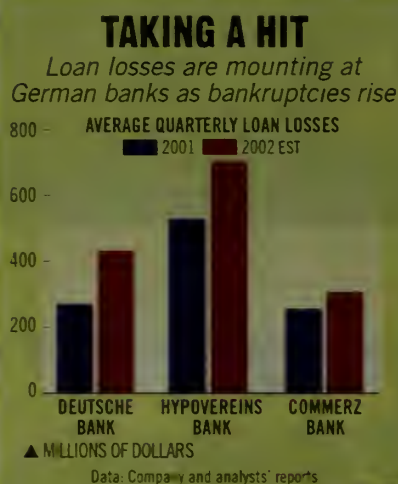
The next day, Albrecht Schmidt, CEO of Germany's second-largest bank, Munich-based Hypo-Vereinsbank, chimed in, saying 2002 is turning out to be "one of the most difficult banking years since World War II." Schmidt then unveiled HVB's first-ever quarterly operating loss—the result of plunging revenues and a 36% increase in loan-loss provisions. Even worse, he said there was little hope of things improving before next year.

Germany's banks are reeling. They've seen record corporate bankruptcies that have sent loan losses spiraling and profits tumbling. To regain their equilibrium, they are embarking on a long-overdue round of layoffs, cost-cutting, and asset sales. The crisis could spark a badly needed series of bank mergers. "These are things that should have happened years ago," says Mark Hoge, an analyst with Bank of America in London. "If they had, Fahrholz wouldn't be talking about a crisis."

As the banks go, so goes Europe's biggest economy. At least 40,000 German companies will fail this year, **"THERE IS A CRISIS":** Dresdner Bank's Fahrholz

according to Creditreform, which gathers data on insolvencies. That's 25% more than last year, the worst year on record. So the banks are reluctant to make new business loans for fear of not being repaid. That makes it harder for Germany, and the rest of Europe, to emerge from its economic funk of the past two years. In any event, the banks aren't in the best of shape to expand lending: Loan-

loss charges will increase by at least 40% this year, analysts predict. Add to that the slumping equity and



bond markets that are hammering banks' investment banking revenue—it's easy to see why Fahrholz and bankers are rattled.

Banks elsewhere in Europe are feeling the pinch. France's BNP Paribas and Spain's Banco Santander Central Hispano just reported sharply reduced first-half profits. But Germany's are experiencing the worst squeeze. German economy is expected to just 0.9% this year, less than much of the rest of Europe. And banks in many haven't merged and streamlined to the same extent as those elsewhere, which means that their costs have stayed high and their profits low. The three largest listed banks—Deutsche Bank, HVB, and Commerzbank—reported returns on equity of less than last year, vs. an average of just 15% for all euro zone banks. "German banks' low profitability is partly the result of their own managerial ineptitude and means [that] they are badly positioned to weather a crisis," notes Hoge.

No one expects any big German banks to go bust: All are well-capitalized to avoid such a fate. Four smaller banks have collapsed, been bailed out in recent months. In late July, rating agency Standard & Poor's said it may downgrade the country's largest local government-dominated banks.

Analysts warn that unless the banks take urgent steps to restructure and improve their performance, they may end up as acquisition targets for foreign investors in two or three years.

The biggest banks appear to be doing just that. Commerzbank is looking for buyers for its U.S.-based Montgomery Asset Management LLC and Britain-based Jupiter Asset Management. Dresdner is mulling the sale of its Dresdner Klein Wasserman, its investment banking unit. HVB and Deutsche Bank are also looking for staff. And Frankfurt is buzzing with speculation that Commerzbank will soon merge with one of its bigger rivals or that some of the government-dominated banks will join.

But with no relief in sight on the economic horizon, a quick turnaround in bank profits is unlikely. It's a possibility that Fahrholz—and other European business leaders—are right to be guarded with increasing apprehension.

By David Fairman
in Frankfurt

EDITED BY ROSE BRADY

AFTER SADDAM: A POWER VACUUM MAY GIVE WASHINGTON PAUSE

The Iraqi exile community is buzzing in anticipation. On July 12, former military officers gathered in an auditorium in London to hear each other denounce Saddam Hussein. Among them were aides to U.S. Secretary of Defense Donald H. Rumsfeld and Vice-President Dick Cheney. Now, Iraqi opposition leaders are preparing to go to Washington for sessions with U.S. officials in mid-August. "These meetings are different from previous ones because the U.S. is getting ready to take action in Iraq," says Ahmed Chalabi, a leader of the Iraqi National Congress, an umbrella organization for Iraqi opposition groups.

Most Arab leaders continue to argue against a military attack on Saddam Hussein. And analysts warn that a war might tip the fragile U.S. economy into recession. But many observers agree that an effort to depose Saddam is in the cards. George W. Bush will look foolish if he doesn't follow through on his threats of "regime change." Saddam is playing into the hands of U.S. policymakers by not letting U.N. weapons inspectors back into Iraq. "I think the U.S. has decided for its own reasons that Saddam is a threat that it cannot live with," says Chalabi, an exile leader based in London.

Now doubt the U.S. will prevail in an all-out military campaign. The key question is how much such an effort will be and where will it end. Much depends on how much help the U.S. can muster from the Iraqi military and civilians in overthrowing Saddam and in running the country. Europeans and neighboring countries worry that replacing Saddam could lead to instability or the rise of an equally menacing strongman. "There has been little political preparation for the inevitable negative reaction in the region and for the follow-on inside Iraq," says a Western diplomat in the Persian Gulf area. U.S. government officials say the upcoming meetings with Iraqi opposition are intended to address such fears. The

U.S. is trying to encourage brainstorming on how Iraq should be governed after Saddam. But Iraq is a notoriously fractious country, and, for now, there is no leader who can command the whole nation's loyalty. Among the guests invited to Washington is a London-based member of the deposed Iraqi royal family, Sharif Ali bin Al Hussein. But other exiles are skeptical about whether the royals, who were ousted in a bloody coup in 1958, have much appeal for contemporary Iraqis.

Indeed, intramural rivalry is running strong. There is friction, for instance, between Chalabi and Ayad Allawi, a former senior member of Saddam's Baath Party who left Iraq in the 1970s and heads the Iraqi National Accord, a longstanding dissident group. Chalabi, a political liberal, has admirers in Washington, but Allawi's group is believed to have better connections to the Baath Party and the Iraqi military. Both men, who say they favor a democratic Iraq, are invited to meet U.S. officials, along with Shiite and Kurdish representatives. That has some exiles hopeful the opposition leaders will bury their differences. "This could be the beginning of not only getting rid of Saddam but building a stable Iraq," says Ghasan Attiyah, editor of *Iraqi File*, a London-based periodical.

It's far from clear how much impact these machinations can have on people in Iraq. Analysts think it's unlikely that the Iraqi military or other groups will risk death to move against Saddam unless they know the U.S. stands behind them. So the U.S. may have to do most of the job itself. "The U.S. has to be willing to invade the country, remove the regime, sit in occupation in Baghdad, and prop up a puppet," says Raad Alkadiri, an Iraq specialist at PFC, a Washington-based energy consultancy. That prospect, along with the negative economic fallout from war, means there will be plenty more talk before there's action.

By Stanley Reed in London



TARGET: Who will take over?

GLOBAL WRAPUP

MAVERICK LOSES HIS TOUCH

In a shocking reversal, Martin Ebner, the maverick Swiss investor, has been forced to sell control of his four investment funds, known as "Visions," to Switzerland's Zürcher Kantonalbank, a local institution. Ebner, who once had a golden touch, has been hit by huge losses in the past two years. The value of the funds has fallen from over \$4.7 billion at the end of 2001 to under \$1 billion, raising questions about financial stability. Indeed, Zürcher Kantonalbank says it is acting in part to

calm a worried Swiss market. Ebner's holding company, BZ Group Holding, was pressured into the move by investors dumping shares in the funds.

Ebner is credited with shaking up Swiss corporate governance—notably by harassing the management of Union Bank of Switzerland until it merged with Swiss Bank to form UBS in 1999. He gained prominence earlier this year when he orchestrated the humiliation of former ABB Chairman Percy Barnevik, forcing him to repay part of a previously undisclosed \$78 million severance package.

But he reached too far. His investments in ABB and Credit Suisse Group have been disastrous. His stakes in the two companies may have cost him as much as \$3.4 billion in losses this year alone. His attempt to force change through taking an 11.4% stake in Investor, the holding company of Sweden's Wallenberg family, has failed, and he is beginning to cut his holding. After the sale of the "Visions" funds, BZ Group will retain direct stakes of 5% in Credit Suisse, just under 10% of ABB, and 9% of Investor.

By Stanley Reed in London

A man in a dark suit is seen in profile, looking out of a window. The window is covered with heavy, dark curtains. The lighting is dramatic, with the man's face and suit partially illuminated by light coming from the window. The overall mood is somber and contemplative.

FALL
FROM
GRACE

JOE BERARDINO presided over the biggest accounting scandals ever and the demise of a legendary firm. Here's what happened

BY JOHN A. BYRNE

T

he day after WorldCom Inc. admitted cooking its books to the tune of \$3.8 billion, former Andersen Worldwide CEO Joseph F. Berardino was glued to the TV set watching CNBC's coverage of the shocking news. Berardino had good reason to be riveted to every development: WorldCom was a major audit client of the firm he had recently quit.

Like the rest of the world, Berardino watched in outrage. But in his case, the ire was directed

at the media, which he believed was exaggerating the story. "They were talking down the market," says Berardino with disgust. Four weeks later, the beleaguered telecom provider filed the largest bankruptcy in U.S. history.

Berardino seems clueless as to how Andersen could have failed to detect the fraud at WorldCom, which occurred over five consecutive quarters. "In a quarter, you're typically not looking at that kind of detail," he says. "It's shocking. It just blows your mind. But why was that stock down to \$1 already? It's because some investors did their homework."

Of course, many are wondering if Berardino, who resigned in disgrace as CEO in March, had done his. At 51, he finds himself exiled from an industry that consumed him for nearly 30 years, a mere bystander to a national debate that will result in the most sweeping reform

of the profession he worked in all of his adult life.

When Berardino

ventured to California in June to give a speech on reform, the *San Jose Mercury News* ran his photo with the caption: "Why would you listen to this man?"

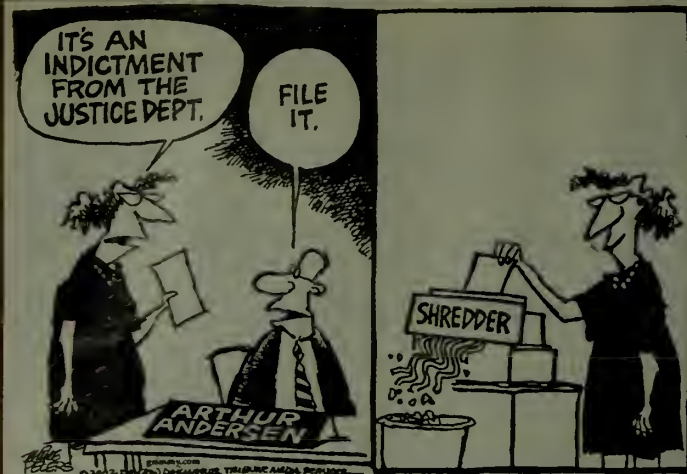
It is not an irrelevant question. Berardino, after all, was at the helm of a legendary firm when it was convicted of obstruction of justice, the same firm that stamped its approval on the dirty books of Sunbeam, Waste Management, Enron, Global Crossing, Qwest, and WorldCom. The scandals that enveloped those corporations alone have cost investors more than \$300 billion and have put tens of thousands of people out of work.

The collapse of Andersen represents an unimaginable failure of leadership and governance. It raises questions about the anachronistic governance structure imposed by a private partnership, a structure better suited to a local enterprise than a global organization. In many ways, Andersen was more like a loose confederation of fiefdoms covering different geographic markets than an in-

Cover Story

CHRIS WADE

**Bitter
new
role:
the
butt of
jokes**



PENCIL USED FOR
OFFICIAL
ENRON
ACCOUNTING



tegrated company. Checks and balances were few and frequently ineffective. Insular and inbred, Andersen was unable to respond swiftly to crises or even to govern itself decisively. It took the firm five months to elect Berardino as CEO. Once in office, he was unable to fire a partner without a two-thirds vote of Andersen's 1,700 partners around the world. Even as the firm was engulfed in turmoil, some partners squabbled over who should be its public spokesman. If it was the head of Andersen's U.S. business, rather than Berardino who was CEO of the worldwide firm, perhaps the crisis could have been confined to America, some thought.

For the firm Berardino once led, the end has been swift. By September, the 89-year-old Andersen expects to have no more than 3,000 employees on its ever-dwindling payroll as it phases out of business. The Andersen name is likely to live on in the popular culture as Watergate did, a shorthand way to refer to a certain kind of scandal. Already, it has become the butt of countless jokes and cartoons. A minor league baseball team in Portland, Ore., for example, recently held an Arthur Andersen appreciation night by stationing document shredders throughout its stadium and handing out receipts with inflated ticket prices.

Berardino's fall from grace has been just as swift. In the space of 15 months, he has gone from being CEO of a \$9.3 billion global partnership with 85,000 employees in 84 countries to a pariah in his industry. Although many of the accounting scandals that helped bring the firm down began festering long before he became CEO, Berardino's emphasis on growth over audit quality, his reluctance to walk away from big clients with questionable accounting, and a stunning ignorance of potentially crippling issues all contributed to the firm's undoing. He claims that he was never told the most basic outlines of the Enron controversy until it erupted into the news.

At times, Berardino, who made an estimated \$3 million a year as CEO, seems to focus more on his personal losses than those of the shareholders and employees who lost investments and jobs because Andersen failed in its duty. "I paid the price," he says in a near whisper. "I lost my job. I lost my firm. I've got less money today than I had as the newly elected CEO [in 2001]. I lost my partner capital. I lost my retirement. I don't have any stock options. I may never work again."

And he seems able to accept only limited responsibility for the catastrophe. "Somewhere north of one person sunk this firm, but it wasn't 85,000 people. Do I bear responsibility? No question. Nobody had to ask me to step down, O.K.?" But he

also blames forces outside of Andersen for the wave of accounting scandals currently afflicting the market. He points to shareholders who invested in companies without examining their filings and to board members who were disengaged and failed to ask the right questions.

The story of what went wrong at Andersen and how a seasoned professional like Joe Berardino could become blind to the problems goes well beyond a few botched, albeit giant audits. It involves a fundamental change in the firm's culture and a breakdown in the values of an industry that once prided itself on serving the public good.

Just 20 years ago, Andersen, along with its brethren in the Big Five, were auditors above all else. Highly trained accountants, they relied on their professional ethics to help manage the tricky business of judging and sometimes countering

the clients who paid the bills. But in the '80s came the rise of the management-consulting business, a broader, less quantitative, and more lucrative line of work that involved a higher degree of salesmanship. Still, auditing went from being the sole business of the firm to a loss leader used to attract and retain the consulting contracts. As the vast riches represented by sales options helped corrupt ethics at corporations, consulting helped push Andersen and its rivals off course. "The culture of the company changed because it got deeply involved in the consulting business," says Paul A. Volcker, former Federal Reserve Board chairman.

The conflict played out at Andersen with especially devastating effect. The cause of the divorce in 2000 of the firm

**“I paid the price.
I lost my job. I lost
my firm I lost
my retirement
I may never work
again”**

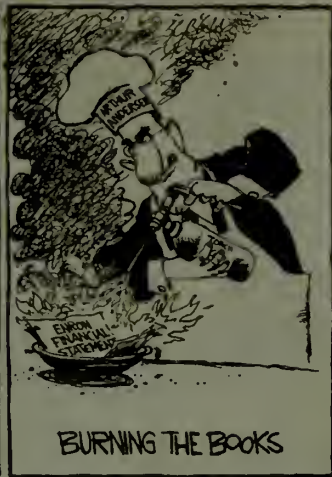
—JOSEPH BERARDINO

Cover Story

consulting and auditing arms. The culmination of 11 years of acrimony, the split left the auditing firm smaller, weaker, and less profitable. The onus shifted to creating a new consulting practice and building revenue. "There is no question in my mind that Andersen took its eye off the ball," says Volcker. "Their compensation practices were based on how much revenue you could generate."

There is no better example of that than Enron, which was paying Andersen about \$1 million a week in 1999 by the late 1990s. Back then, Enron was lionized in the press and among management gurus for its radical business model, just the kind of fast-growing client Andersen was desperate to cultivate. At Enron, Andersen's consulting revenues exceeded its audit fees for the first time in 1999. The following year, Enron paid \$27 million for Andersen consulting services and \$25 million for audit work.

Were those consulting fees enough to cause Andersen to lower its guard? Berardino says not. He says the auditing



considered "high risk."

That alone should have been enough to put Enron front and center on Berardino's radar, but that did not happen. There were plenty of other signs of trouble, signs that Berardino says never reached him. In February, 2001, Andersen partners

o huge to begin with that if the firm were vulnerable to swayed, that alone would have been enough. And, he that didn't happen.

t regardless of whether the fees played a role, it's clear Andersen's work at Enron had been compromised long e the energy giant's final flameout. As head of Andersen's audit practice for nearly three years before becoming n January, 2001, Berardino had helped to lead an exer-hat evaluated the "risk profile" of each of the firm's 2,500 clients. During that review, Andersen grouped its s into four categories: maximum, high, moderate, and low Enron was one of some 50 clients deemed imum risk," while 700 were

in Chicago, worried about Enron's aggressive accounting, were actively debating whether to retain Enron as a client. Meanwhile, Andersen's audit team at Enron was having increasingly heated internal conflicts. A senior Andersen partner, Carl E. Bass, who had been sent in to monitor the high-risk audit, strongly objected to Enron's accounting. Berardino paid a call on Enron CEO Jeffrey K. Skilling and Chief Accounting Officer Richard A. Causey that same month at Enron's Houston headquarters. Berardino says it was strictly a meet-and-

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for nearly a century

Andersen begins
ulting, working with
to install the first main-
ne computer at General
ctric to automate its
roll systems

72 Joseph Berardino joins
e firm's New York office

978 With \$546 million in
evenue, Andersen becomes
he largest professional-
services firm in the world

1984 Andersen's consulting
business rakes in more profit
than auditing for the first time

1989 The accounting and
consulting practices break



ARTHUR
ANDERSEN

into two separate, and often
warring, firms under a Swiss-
based parent

APRIL, 1998 Berardino
becomes head of Andersen's
U.S. audit practice

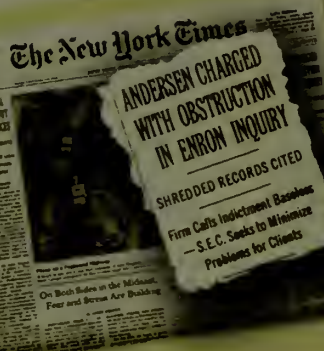
JUNE, 1998 Andersen with-
draws its unqualified audit
for Sunbeam, which later
restates its financials

2000 An arbitrator rules
that Andersen Consulting
can break free by paying \$1
billion, in-
stead of the
\$15 billion
auditors had
expected

**JAN. 10,
2001**
Berardino is
named chief
executive

JUNE, 2001
Andersen
agrees to pay
a \$7 million
fine, the largest SEC penalty
ever paid by an auditor, after
the agency found it respon-
sible for faulty audits at
Waste Management

**JAN. 10,
2002**
Andersen
says a
number of
documents
were
destroyed at
its largest
client,
Enron,
which paid
the firm \$52 million in audit
and consulting fees in 2000



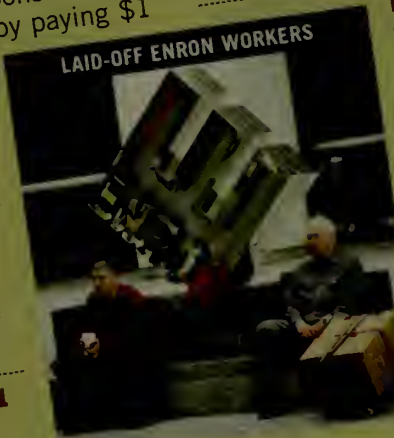
MAR. 22
Volcker
outlines his
plan to
rebuild
Andersen as
a pure audit
firm that
would serve
as a new
model for
the industry

MAR. 26 Berardino steps
down as CEO

JUNE 15 A jury convicts
Andersen of obstruction
of justice

JUNE 25 Andersen auditor
Melvin Dick says he was
duped in the \$3.8 billion
WorldCom fraud

Data: BusinessWeek



LAI-D-OFF ENRON WORKERS

FEB. 3 The
firm hires
ex-Federal
Reserve
Board
Chairman
Paul Volcker
to help
reform it

MAR. 14 The
Justice Dept.
indicts the
firm for
obstruction
of justice in the Enron case



BERARDINO AND VOLCKER



MELVIN DICK AND BERNIE EBBERS



UNEMPLOYED
AND DISTRAUGHT
IN GEORGIA

Stumble After Stumble

Andersen may not have presided over the most auditing goofs, but it did have some of the biggest. Here's what several of them cost the public

* Loss in total market value from peak stock price to date

** Announced job layoffs

† Loss to investors

Data: Compustat via FactSet Research Systems

CLIENT / WHAT ANDERSEN AUDITORS MISSED	LOSSES TO SHAREHOLDERS*	JOB LOSSES**
WORLD COM Company inflated earnings, leading to a \$3.8 billion restatement	\$179.3 billion	17,000
ENRON Variety of schemes that inflated income by \$586 million, leading to restatement and bankruptcy	\$66.4 billion	6,100
GLOBAL CROSSING Andersen audited financial statements 11 months before company, whose accounting is under investigation, filed for bankruptcy	\$26.6 billion	8,700
WASTE MANAGEMENT Company overstated income by \$1.1 billion for years 1992-1996	\$20.5 billion	11,000
SUNBEAM Company overstated 1997 net income by \$71.1 million, helping to push it into bankruptcy	\$4.4 billion	1,700
BAPTIST FOUNDATION OF ARIZONA Largest nonprofit bankruptcy ever in a cook-the-books scheme	\$570 million†	165

greet, that he didn't confer with the Andersen audit team on the Enron account before the visit, didn't know about the conflicts over the accounting, and never discussed them with Enron. He says it's a coincidence that within weeks of his visit, Bass was removed from his oversight role, at Enron's request.

"If that kind of issue isn't important enough to get to Berardino's desk, then what is?"

Cover Story

asks Allan D. Koltin, CEO of the Practice Development Institute, a consulting firm that specializes in the accounting industry. "He either knew and chose to look the other way or he had to be the most incompetent CEO in America."

Bass was a member of Andersen's Professional Standards Group, an internal team of accounting experts that reviewed and passed judgment on tricky accounting issues facing local offices. He found plenty to keep him busy at Enron, where he had once helped audit the books. In a Dec. 18, 1999, e-mail, Bass documented a conflict over how Enron should account for the sale of options owned by one of the partnerships managed by Enron Chief Financial Officer Andrew S. Fastow. If the Andersen team had accepted Bass's advice, it would have resulted in a \$30 million to \$50 million charge to Enron's

earnings. An Andersen vice director in Houston, however, overruled Bass, who continued to object to the accounting transaction the next couple of months. Andersen was the only member of the Big Five where a partner could overrule Professional Standards.

In retrospect, the steps for airing such conflicts that Andersen seemed designed to ensure that top executives learned of them. Instead, they were handled several months down in the organization, with people with clear incentives to maximize earnings. Berardino denies the system was flawed, but probably wouldn't have anything differently than the team," he says. Berardino thought Andersen could manage the risk, but says the firm walked away from hundreds of clients, especially after the risk assessment pointed up dicey. But he acknowledges that rejected clients tended to involve smaller fees and engagements. "It was hard to start with the big ones," he says. "We had to learn to walk before we could run."

Even with Andersen's death throes, there's an unreality at the firm, a misreading of the events that led to its downward spiral. Partners there will still insist that Berardino was not objective enough in defending Andersen from the Justice

Dept., which they claim was hell-bent on destroying the partnership. "He probably should have been a street fighter and told them they were a bunch of liars who weren't interested in the public good," says Aldo Cardoso, a Paris-based partner who is acting CEO of Andersen Worldwide. The Justice Dept. is responsible for the collapse of the financial markets because they caused our collapse."

That's in contrast to the prevailing view outside the firm. Berardino "never said he took full responsibility for this," says Arthur W. Bowman, a longtime industry observer and founder of *Bowman's Accounting Report*. "That was the problem with everyone at Arthur Andersen. They are all so arrogant that none of them wants to take responsibility."

When Berardino joined the firm's New York office in 1980, it was with a sense of mission. Founded by a Northwestern University accounting professor in 1913, Andersen stood for integrity. Just months after Arthur Andersen set up shop in Chicago, the president of a local railroad insisted that Andersen approve a transaction that would have inflated earnings. Andersen told the executive there was "not enough money in the city of Chicago" to make him do it.

In the spirit of the company's founder, Berardino saw himself as a public guardian. An early role model was Pete Kenne-

Joe was blind to the conflict. He was the most aggressive pursuer of revenue that I ever met

—EX-ANDERSEN PARTNER BARBARA LEY TOFFLER

ian partner from Berardino's hometown of Garden City, who taught him to stand his ground. An audit was not a collection of numbers, Kennedy insisted, but a position had to be intelligently made and defended.

Berardino climbed the firm's ladder, becoming a partner in and acquiring such top-notch audit clients as Merck & Co. and Colgate-Palmolive Co. But over the course of nearly 20 years of presentations to audit committees, he says he found himself far too complacent and disengaged: "Nobody fell asleep, but many of them didn't understand the business. They just sat there and received reports," he says. "Some directors just don't want to know. They might have to do something about it."

While Berardino focused on his auditing work, a profound change was unfolding inside his firm and the other major audit firms. Much of Andersen's growth was coming not from accounting and auditing but rather from a wide array of consulting work, from installing information technology systems to providing advice on tax avoidance. One recent study in *The Accounting Review* showed that the consulting practices of the Big Five accountants brought in three times as much revenue as auditing in the 1990s.

Andersen's firm was more successful in consulting than Andersen, which boasted the largest and fastest-growing network of consultants in the world. Indeed, it was a concern in Washington that the profit consulting work was becoming a commodity. In some cases, by taking over the internal audit functions of clients, Andersen and its Big Five rivals were effectively auditing their own work.

In the fall of 1998, Securities and Exchange Commission Chairman Arthur Levitt Jr. went public with his attack on the industry. "Accounting is being perverted," he said. "Auditors and analysts are participants in a game of nods and winks." He urged new rules to protect the ability of the accountants to consult for the same companies they audited. At a meeting between the SEC and Big Five accounting-firm CEOs in 2000, Andersen's then-Chief Executive Officer W. Robert Grafton was to declare: "This is war."

It fell to Berardino, as head of Andersen's U.S. audit practice, to negotiate a compromise with the SEC, which he did in late 2000. It was a testament to his political skills that Berardino is viewed in Washington as a conciliator who forged a compromise pact, while at Andersen he was viewed as the man who stared down Levitt and won. In the end, the deal he struck merely delayed public disclosure of audit consulting fees, not a prohibi-

tion from signing consulting contracts with audit clients. Levitt says he considers Berardino to have been far more reasonable to deal with than his rivals. "He was different," says Levitt. "He was civil, measured, and thoughtful."

Berardino's handling of the crisis helped him gain election as chief executive in January of 2001, with 90% of his partners' votes. "It was the dumbest reason to elect a person CEO," says Lynn Turner, former chief accountant of the SEC. "They should have elected someone who realized that their customer was the investing public and who could deliver high quality audits."

But while Berardino may have reached a truce in Washington, he was grappling with a highly divisive war inside Andersen. Once consulting had eclipsed auditing in profitability, by 1984, the consulting partners began getting restless. They wanted their pay to reflect the success of their business, which was driving Andersen's growth. The dispute led to warring factions inside the firm that ultimately became so toxic it would rend Andersen in two. In 2000, an arbitrator ruled that Andersen Consulting, with \$9.4 billion in annual revenues, could break free merely by paying \$1 billion and changing its name. (It is now called Accenture.)

The decision was a huge setback. The auditors, some expecting a payment as high as \$15 billion, were shocked. "There was so much anger, and the leadership was obsessed with what was going

on," says a former partner. Overnight, Andersen went from being the world's largest professional-services firm to the smallest of the Big Five accountants. Concedes Berardino: "It was a major distraction."

That led Berardino to shift the emphasis even more strongly toward building revenues by rebuilding the consulting practice. The firm's long-held beliefs, known as "the four cornerstones," were to provide good

client service, produce quality audits, manage staff well, and produce profits. But as the pressure to bring in more money grew, some partners began to grouse that the four cornerstones had become "three pebbles and a boulder." Berardino acknowledges those complaints. "Some of our partners thought that that was happening," he says. "I didn't."

The focus on consulting left little time to ponder the quality of the firm's audits. "When Berardino would get up at a partners meeting, all that was ever reported in terms of success was dollars," says Barbara Ley Toffler, a former Andersen partner from 1995 to 1999. "Quality wasn't discussed. Con-

Joseph Berardino

BORN Dec. 29, 1950, New York.

EDUCATION BS Fairfield University, 1972.

CURRENT POSITION Unemployed.

BEGINNINGS Raised in Garden City, N.Y.; dad was a State Farm insurance salesman; he was an altar boy at St. Ann's Church; played Little League baseball and once hit into a triple play.

CAREER Joined Arthur Andersen's New York office as a junior accountant in 1972 for \$11,400 a year, became a partner in 1982, elected CEO in 2001, and resigned in March.

WHAT HE EMPHASIZED AS CEO The need for revenue growth in wake of the nasty break with the high-profit consulting group.

BEST QUESTION FROM A DIRECTOR DURING ONE OF HIS NEARLY 300 AUDIT PRESENTATIONS "What would you guys do if we increased your fees by 25%?"

PLANS FOR FUTURE Uncertain, but he's not yet looking for work. "I can sell hotdogs if I have to. I'm just not ready yet. I'm too beat up."

FAMILY Married to Gail in 1977; two daughters, Andrea and Allison.



OFF TO THE JUNIOR PROM

tent wasn't discussed. Everything was measured in terms of the buck," adds Toffler, who is writing a book with former *BusinessWeek* editor Jennifer Reingold. "Joe was blind to the conflict. He was the most aggressive pursuer of revenue that I ever met."

Berardino soon found himself consumed with one crisis after another. In May, 2001, he agreed to pay \$110 million to settle

Cover Story

shareholders' claims in an accounting scandal at Sunbeam Corp. A month later, he paid nearly \$100 million more to settle similar claims at Waste Management Inc. and \$7 million to settle the SEC case for its role in approving Waste Management's fraudulent audits. In both cases, Andersen did not admit guilt. Berardino has no explanation for how his firm could have been so lax.

The garbage hauler was an early example of Andersen

collecting more for consulting than auditing. That disturbing pattern would continue. Last year, Qwest Communications International Inc., now under investigation by the SEC and the Justice Dept., paid Andersen \$10.5 million for consulting and \$1.4 million for its audit. The telecom provider said it overstated revenue for 1999, 2000, and 2001 by \$1 billion.

When Enron hit in the fall of 2001, Berardino tried to contain the crisis by showing up on Capitol Hill and admitting to some mistakes. He rushed off to meet with audit committees of more than 20 Andersen clients, hoping to persuade them to stay. It wasn't until early March when he was awakened in the middle of the night in a Tokyo hotel room, that he realized the entire firm could be vulnerable. Andersen's lawyers told him then that the Justice Dept. was inclined to indict the firm. "The indictment was enough to kill us," he says. "That's what we were afraid of."

Berardino says he worked frantically to turn the Justice Dept. around. He got Volcker, hired in February, to create an independent oversight board to revamp the organization and announce reforms that would transform Andersen into a pure audit firm and lead a new management team. But on March 14, Justice went through with an indictment for obstruction of justice. The very next day, Berardino says, he

offered to step down during a conference call with Andersen's 18 directors. But they insisted that he stay. "I said, 'At some point, we may want me to go to this. I don't want you going to a meeting in bars worrying about it.'"

On Mar. 26, he finally signed. Berardino says it was a sort of Hail Mary pass to the Justice Dept. to reconsider. It didn't work, and on June 15, a judge in Houston convicted the firm of obstruction of justice, though not of accounting fraud.

Berardino still commutes from his home in Greenwich, Conn., to his office on the 11th floor of a Manhattan skyscraper twice a week. But when a partner sticks his head in the door these days, he's not there to talk about business. Instead, he's likely to be saying a final goodbye. Some partners

told him that when they tuck their children into bed at night, they have to reassure the kids that they're not going to jail. "It's devastating," says Berardino. "You find out who your friends are in your wake."

He is vague about his future. "A lot of people come up to me and say, 'I feel sorry for you,'" he says. "This will sound Pollyanna-ish, but I now know who my friends are. I now know what I'm made of. My integrity is intact."

Maybe so. But history is likely to judge his performance harshly.

LEARNING FROM MISTAKES

Former Arthur Andersen Worldwide CEO Joseph F. Berardino desperately wants to have a voice in the ongoing debate over accounting reform. But not too many people are listening to him. Like Coleridge's Ancient Mariner, he seems a forlorn figure, destined to mouth warnings that no one hears.

When Berardino spoke at a recent Stanford University seminar for board members, he was greeted with a mixture of cynicism and curiosity. "There was a very skeptical group who thought everyone associated with Andersen is tarred in perpetuity," says Joseph A. Grundfest, a Stanford professor. "They can't tell how much of Joe's message is sincere and how much of it is post-crisis positioning."

Still, Berardino had a unique view of the accounting crisis that afflicts Corporate America. The irony is that some of his ideas may be worth considering even if his credibility is nil. Among them:

- Rather than a pass-fail system of approving financials, auditors should hand out report-card grades that reflect the quality of a client's accounting. That would give auditors more leverage over clients in accounting disagreements and also enable the market to give a premium to companies that get the highest marks and discount those that get the lowest grades.

- Change the focus of directors so that they're involved in risk management, not the verification of financials. The most important questions that a director can ask: "What are the most significant risks to this company, how likely are they to occur, and what is management doing about them?"

■ Change the financial-reporting system so it is based less on "a game of rules, loopholes, and legalisms" and more on principle-driven

accounting—the approach of the International Accounting Standards Board.



en accounting—the approach of the International Accounting Standards Board.

- Require each accounting firm to put three or four outsiders on its board of directors to make these private partnerships less insular and inbred.

Berardino is gloomy about the prospect for change. "My fear is that we'll go through another year of looking for scapegoats." The question is, will anyone heed the warning?

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WHY P&G'S SMILE IS SO BRIGHT

With the fast-growing SpinBrush, the company bent its own rules—and won

Darin S. Yates had watched many consumer focus groups at Procter & Gamble Co., but he had never witnessed a response like this. Out of a panel of 24 consumers evaluating a new electric toothbrush, 23 raved about the product, begging to take it home. "We were just blown away," the 36-year-old brand manager recalls.

But Yates, team leader on the new toothbrush, never imagined how successful the Crest SpinBrush would be. While most electric brushes cost more than \$50, SpinBrush works on batteries and sells for just \$5. Since that focus group in October, 2000, it has become the nation's best-selling toothbrush, manual or electric. In P&G's last fiscal year, it posted more than \$200 million in global sales, helping Crest become the consumer-product maker's 12th billion-dollar brand. It has also helped Crest reclaim the title as No. 1 oral-care brand in the U.S., a position it lost to Colgate-Palmolive's Colgate brand in 1998. "It's hard for P&G's business models to conceive of a business growing as quickly as SpinBrush," Yates says.

One reason is that P&G didn't conceive SpinBrush to begin with. Four Cleveland-area entrepreneurs developed the gizmo in 1998 with the idea of selling it to P&G. They parlayed a \$1.5 mil-

lion investment into a \$475 million payout. Three of them even went on the P&G payroll for a year and a half to shepherd the product—something unheard of at the insular company. Says John Osher, the lead entrepreneur behind SpinBrush: "My job was to not allow P&G to screw it up."

SpinBrush marks a dramatic departure for the 165-year-old company. For once, P&G didn't insist on controlling every step, from product development to pricing. Instead, it harnessed its greatest strength—the ability to market and distribute products—to the innovation and risk-taking ability of a tiny startup that wasn't constrained by the culture inside P&G's Cincinnati headquarters. The strategy is not without risks or cultural challenges. P&G had to bend on how it packaged, manufactured, shipped, and worked its mighty marketing machine. And the story isn't over: The SpinBrush founders question if the product will reach its potential once it is fully enveloped in P&G's big-company culture. "I'm not sure you can teach an elephant to dance," Osher says.

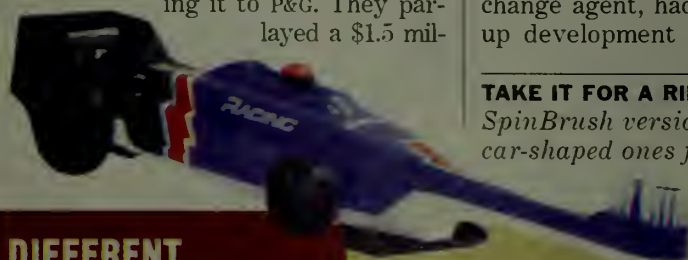
Even so, the acquisition of SpinBrush says a lot about the leadership of Alan G. Lafley, who became chief executive in June, 2000, when predecessor Durk I. Jager was ousted. Jager, a combative change agent, had pushed P&G to ramp up development of new products. He

shook P&G's identity with proposals to buy two large pharmaceutical companies. In the end he overreached, missing earnings forecasts.

Lafley has been more deft. He refocused the company on the brands that drive earnings, including Pampers, Tide, and Crest. Like Jager, he has made acquisitions. But the \$10-billion purchase of Clairol, P&G's hair-care unit, and SpinBrush have been close to P&G's core strengths in hair and skin care than Jager's forays with Iams dog food and PUR water-filter systems.

Those moves have helped Lafley strike a balance between sales and profit growth—something that eluded his predecessor. P&G has exceeded Street's earnings estimates in the three reported quarters, while at the same time increasing share in its markets through higher promotional advertising spending. For the fiscal year ended March 30, analysts expect P&G's operating earnings to climb 9% to \$5 billion, reversing a prior-year decline. Such gains will come harder, though, as savings from a \$1-billion restructuring started under Jager start to wind down.

Still, Lafley is proving to be a more strategic thinker by P&G standards. When Kimberly-Clark Corp. launched a moist toilet paper last year, he pushed back against P&G's make-it-here mentality by acquiring a manufacturer of a similar product. That let him parry Kimberly-Clark more quickly and tied up less money in the capital-intensive business. Reversing negotiations to outsource P&G's 6,000 employee, back-office operations was



TAKE IT FOR A RIDE P&G has various SpinBrush versions, including car-shaped ones for kids

DIFFERENT STROKES FOR P&G

The marketing giant broke a lot of its own rules when it launched the SpinBrush. Here's what it did:

LOOKED OUTSIDE

SpinBrush wasn't invented at P&G. Instead, the company bought it from a group of entrepreneurs.

EMPOWERED THE INVENTORS

To make sure the new toothbrush didn't get smothered by the P&G bureaucracy, the inventors were hired for the first year to help with everything from packaging to logistics.

GOT AGGRESSIVE ON PRICE

Instead of starting at high end and cutting as competitors moved in, P&G started low and made it harder for newcomers to steal market share.



SPIN DOCTOR: *John Osher and his colleagues sold their idea to P&G*

also have been unlikely at the old P&G. The move reflects Lafley's efforts to focus the company on its core strengths and suggests further payroll cuts ahead.

The SpinBrush saga also shows a new recognition that not all great ideas originate at P&G. Lafley has made clear that as many as a third of P&G's new product ideas may come from outside, and he has stepped up efforts to identify and acquire other small companies. But perhaps the biggest change for P&G was in SpinBrush's pricing. P&G usually prices its goods at a premium, based on the cost of technology. But competitors now follow new products more quickly, eroding P&G's pricing power. With SpinBrush, P&G reversed its usual thinking. It started with an aggressive price, then found a way to make a profit. If P&G had conceived SpinBrush, admits Yates, "my gut tells me we would not have priced it where we did."

That's just the opportunity John Osher and his three colleagues saw when they had the SpinBrush brainstorm back in 1998. Osher, 55, had spent most of his career inventing things and selling them to big companies. His latest creation had been the Spin Pop, a lollipop attached to a battery-powered plastic handle, in which the candy spun at the press of a button. He had teamed up on the Spin Pop with John R. Nottingham and John W. Spirk, the principals of a Cleveland industrial design firm, and their in-house patent lawyer, Lawrence A. Blaustein. The Spin Pop had recently sold to Hasbro for millions and the men were looking for another way to utilize the technology.

They can't remember who came up with the concept, but they know it came from their group walks through the aisles of their local Wal-Mart, where they went for inspiration. They saw that electric toothbrushes, from Sonicare to Interplak, cost more than \$50 and for that reason held a fraction of the overall toothbrush market. They reasoned: Why not create a \$5 electric brush using the

SKIPPED THE NEW PRODUCT ADS

To meet that low price, P&G passed on a lavish launch campaign and relied instead on packaging that allowed customers to turn the brush on in the store.

The Corporation

Spin Pop technology? At just \$1 more than the most expensive manual brushes, they figured many consumers would trade up. They spent 18 months designing and sourcing a high-quality brush that wouldn't cost more than \$5, batteries included. "If it had cost \$7.99, we wouldn't have gone forward," Osher says.

They also formulated an exit strategy: Sell it to P&G. In 1998, they saw that Colgate toothpaste was dethroning Crest, the market champ since the early 1960s. Colgate edged out Crest by launching Total and pitching it around the new theme of whitening. P&G, meanwhile, clung to its cavity-fighting message. Colgate gained 5.6 percentage points of market share in 1998, giving the company 29.6% of the market, vs. P&G's 25.6%. "We knew that P&G would be very hungry," says Nottingham.

But first they had to prove the product could sell. They couldn't afford to advertise and sell SpinBrush at that low price. So they resorted to the marketing ploy they used with Spin Pop: packaging that said, "Try Me" and that allowed the consumer to turn the brush on in the store. They also hired a former Clorox salesman, Joseph A. O'Connor, who had years of experience selling to Wal-Mart and other big chains.

When they tested SpinBrush in Meijer Inc., a Midwest discount chain, in October, 1999, it outsold the leading manual brush nearly 3 to 1, convincing Meijer to carry it. Using that sales data, they cracked drugstore chain Walgreen Co. and caught the interest of Wal-Mart in early 2000. To help close that deal, O'Connor persuaded a health and beauty aid manager at a Phoenix Wal-Mart to buy 240 SpinBrushes. "They sold out over the weekend," he recalls.

In 2000, the entrepreneurs sold 10 million SpinBrush units, more than triple the existing 3 million U.S. electric toothbrush market. With that record, it wasn't hard for Osher to get an appointment at P&G in July. The company had another reason to take notice: Colgate's recently launched ActiBrush electric toothbrush, at \$19.95, was off to a fast start, too.

Yates, a financial manager on the Crest brand, headed a team to

evaluate SpinBrush. P&G code-named the project Julius, after basketball great Julius Erving. With approval to negotiate a purchase and focus group reactions off the charts, Yates moved fast. A deal to buy the startup closed in January, 2001, six months after the first meeting with Osher.

The deal's structure was unprecedented for P&G. Instead of paying a lump sum, P&G would pay \$165 million up-front with an "earn-out" payment in three years based on a formula pegged to financial re-

worried about having more autom factories in China. In the end, tho "they would listen to us and fight own bureaucracy," says Osher.

Yates broke the the biggest rule for a company whose heritage is in kiting—he didn't advertise SpinB for the first seven months. The t tional P&G model for a launch calls heavy TV advertising from the on and a high enough price to help c that cost. But Yates didn't want th expense, which could force him to prices, until sales could support it

RADICAL LEADERSHIP
CEO Lafley has gone against P&G's make-it-here mentality, looking outside for winning new products



sults. The up-front payment alone—nearly four times SpinBrush's prior year sales of \$43 million—was rich by P&G's standards. The company paid three times sales for Clairol. But P&G was banking on faster sales growth from SpinBrush.

The deal had another unique feature: Osher, Blaustein, and O'Connor agreed to join the company for the three-year earn-out period with a mandate of keeping the business entrepreneurial. They would become part of a 27-person team headed by Yates that would have authority to bend any P&G rules that interfered with the business. The entrepreneurs would guide the team and had carte blanche to go higher within P&G to resolve conflicts.

And there were conflicts aplenty. Some P&Gers questioned the "Try Me" feature, fearing the batteries would wear out. Others wanted to stop store deliveries for three months so P&G could build inventories. Still others

didn't want to mess up the economic structure of the business," he says.

P&G now sells SpinBrush in about 100 countries, marking its quickest global rollout ever. And it's added a multitude of models, including ones with replaceable heads. Colgate earlier this year launched Motion, a SpinBrush look-alike at the same price. In a recent earnings conference call, Colgate CEO Reuven Mark admitted that the company cut the price of ActiBrush from \$19.95 to \$12 because of the competition.

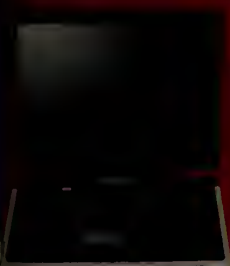
P&G and the SpinBrush founders agreed to an early payout in March, months ahead of schedule. Osher's employment contract ended that month, and O'Connor's and Blaustein's ended in June. P&G pushed for the deal because SpinBrush's sales so far exceed plans that the company faced the prospect of a much bigger payout if it waited, Osher says. The founders set on a final payment of \$310 million. The total price of \$475 million was about 10 times last fiscal year's sales, a price some analysts consider a steal.

But Osher and his partners had their own reason for getting out early—they wanted to hedge their bets. They're uncertain whether SpinBrush will live up to its potential as it is further folded into P&G. Osher had an exit interview with Lafley in May in which the CEO vowed to keep SpinBrush on course. Osher has no doubt about Lafley's sincerity. It's just that he is still not sure an elephant can learn to dance.

By Robert Berner in Chicago

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XEROX HAS BIGGER WORRIES THAN THE SEC

The real numbers are weak, and the company must sell Wall Street on a growth plan

Xerox Chairman and CEO Anne M. Mulcahy has been trying hard for months to leave the past behind. In April, Xerox Corp. settled Securities & Exchange Commission charges that from 1997 to 2000 it fraudulently inflated revenues by more than \$3 billion and pretax earnings by \$1.5 billion. "The SEC matters [are] now behind us," Mulcahy declared.

Then on June 28, Xerox filed its 2001 annual report and with it new numbers for the past five years calculated according to the SEC's demands. The copier maker restated \$6.4 billion in revenue—double the sum that the SEC had flagged—and reduced operating income by a staggering 43%. Noting that these changes reflected shifts in the timing of revenue and earnings, not their disappearance, Mulcahy quickly announced once again that Xerox' "new management team has put the past behind us."

But despite Mulcahy's protestations, the past weighs heavily on Xerox. The SEC, which has settled with the company, is still investigating departed executives—including two former CEOs G. Richard Thoman and Paul A. Allaire and former CFO Barry D. Romeril—and Xerox' former auditor, KPMG. Beyond that lies a bigger problem. For the past two years, as management focused on the accounting scandal and a huge debt load, rivals have been stealing Xerox customers at a rapid-fire rate, luring them with improved technology and lower prices. "Xerox lost sight of its competition," says Angele Boyd, a vice-president of IDC, a Framingham (Mass.) research firm.

Wall Street has shown little faith that Xerox has left its problems behind. On revenues of \$17 billion for 2001, the company reported a net loss of \$71 million.

The stock price, meanwhile, has dropped 38% from a 2002 high of \$11.45 on Jan. 29, to a recent \$7. That's much worse than the 18% slump in the Standard & Poor's 500-stock index over the same period and leaves Xerox at one-tenth of its 1999 high of \$64. "There are a lot of investors who have been through some very tough times," says Bill Nygren, manager of the Oakmark Fund, which holds 6.5 million Xerox shares. "If the company's in the headlines in a negative way, they're going to sell."

Two weeks after the restatement was made, in a 1,000-page SEC filing, analysts were still struggling to figure out the implications for future earnings and cash flow. Combined with a heavy debt load, that lack of clarity has made it "hard to get enthusiastic about Xerox," according to Credit Suisse First Boston analyst Gibboney Huske, who rates the stock a "hold."

Stiff competition, fantastic billing screw-ups, and overpriced machines have been problems at Xerox for years. In its April complaint, the SEC accused the company of trying to make up for slipping operating earnings with accounting maneuvers as early as 1997. According to the SEC, for 12 consecutive quarters starting that year, Xerox used accounting tricks to compensate for profit shortfalls. At the time, the company was marketing itself to investors as a growth stock, with a goal of double-digit revenue growth and earnings improvements in the mid-teens, astonishing

“Our new management team has put the past behind us”

CEO MULCAHY

bers for the mature copier market. Today, Xerox has a tamer, though still engaging, goal of 5% annual revenue growth by 2005. But the company is also at a worse competitive disadvantage. In the past three years, its share of the black-and-white copier market has slipped from 27.5% to 14.9% as value-conscious buyers abandoned high-priced Xerox for Canon and Ricoh. Losing customers is a double whammy for the company, which loses not only new copier sales but also the annuity income from service contracts and parts it had been supplying on old machines.

At one customer, AlphaGraphics Inc., a chain of franchised print shops based in Salt Lake City, Xerox went from a near-monopoly position in 1995, supplying roughly 90% of the high-speed copiers and printers in AlphaGraphics' locations, to less than 20% in 2000. Instead, AlphaGraphics uses more Canon machines, which print fewer pages per minute but are just as reliable and cost 85% less than Xerox. "We got blown out of the water," says Mike Witte.

Choice business with Coca-Cola Bottling Co. and other blue chips, which typically sign multiyear contracts, will be tougher for Xerox to win back from rivals. Today's digital

copiers are increasingly connected to corporate computer networks, a process much more involved than plugging in a machine. "The more tightly integrated to the customer we are, the more difficult it gets to replace us," says Dennis Amoroso, director of Canon Inc.'s copier and office systems business.

And Xerox' competitors are not letting up. Ryoichi Bamba, who runs Canon's U.S. office-equipment business, predicts the company's 34% market share will reach 40%.

To fight back, Mulcahy is trying to make Xerox more price-competitive—as she focuses on those sectors with the best growth potential, such as high-end color printing and services. In June, Xerox introduced its next generation of copiers, some of which shoot out more pages per minute at a lower cost than Canon's latest offering. Mulcahy has maintained research and development spending. She says that better color copiers for offices helped the company get to profitability in the second quarter of this year and regain some market share. Xerox also says it has defended and expanded its relationship at big customers including Merck

and Unisys and won new ones such as restaurant chain Boston Markets from Canon. "We've been through a turnaround in terms of stabilizing the business model," says Mulcahy, who took the top job last August. "Now, we're really focused on the top line." (For a Q&A with Mulcahy, go to page 64.)

Mulcahy is also logging a lot of hours with customers—more than 50% of her time, she estimates. Hired

just two years out of college to join Xerox' salesforce 26 years ago, Mulcahy has shown an ability to please customers no matter how irate. In January, AlphaGraphics CEO Witte asked her to fly to South Florida to meet with 70 franchisers. For 2½ hours, Mulcahy stood in the middle of the room fielding questions and complaints about everything from service levels to Xerox' fa-

mously troubled billing system. "These people took off the gloves and went after her, and she wasn't afraid to apologize," says Witte. "She is very customer-focused. For Xerox, that's an enormous change." Franchisees gave her points as well for quickly following up on their specific complaints.

She has tried to get the company to follow that example. Faced with what one former executive calls "Xerox' culture of denial," Mulcahy has removed obstructionists and yes-men from her team. With the exception of new Chief Financial Officer Lawrence A. Zimmerman, an IBM veteran, Mulcahy

has entirely remade top management by promoting from within, putting a premium on candor. "This is a more outspoken management team," Mulcahy says.

But not everyone has found Mulcahy's Xerox to be sufficiently straightforward. The SEC took the unusual step of publicly lambasting Xerox for failing to cooperate with its two-year investigation of the company. It imposed a \$10 million fine, the largest ever for a financial reporting violation. "Given how long it took the Xerox management team to get to the right numbers, only time will tell if top management at Xerox has really changed their culture," says Lynn Turner, a professor at Colorado State University who was chief accountant of the SEC at the time the Xerox investigation was launched.

Mulcahy, who was never personally called on by the SEC and who is not under investigation, says the company has cooperated fully. She is confident that

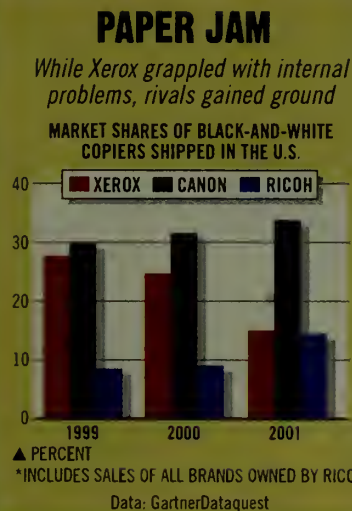
she's the right person to tackle the many challenges still facing Xerox, including an additional \$5.8 billion in debt coming due during the next 18 months. "In the past two years, I have probably made tougher decisions than most CEOs," she says. Many more await.

By Nanette Byrnes in Stamford, Conn., with Anthony Bianco in New York



If the SEC prosecutes former executives, bad publicity will again haunt management

EX-CFO ROMERIL AND EX-CEO ALLAIRE



LESSONS FROM A BAPTISM BY FIRE

As a survivor of trials by fire, Xerox Corp. Chief Executive Anne M. Mulcahy has few rivals. She became president of Xerox in May, 2000—a month before the Securities & Exchange Commission launched its investigation of the copier maker's financials—and stepped up to the top job last August.

In the past two years, Mulcahy, 49, a lifelong Xerox staffer, has reworked her entire top management team, renegotiated a \$7 billion bank line of credit, settled an SEC fraud complaint against the company, and restated five years of financial filings. Now she faces a more challenging task: pushing the company back to a healthy growth rate. On a recent Sunday afternoon, as she prepared for a trip to Europe to meet with customers and staff, Mulcahy talked in her Stamford (Conn.) office with BusinessWeek Associate Editor Nanette Byrnes.

On June 28, Xerox filed its belated 10-K, including all of the restatements you had agreed to in your April settlement with the SEC. It is close to 1,000 pages long. As someone who made

her career as a saleswoman, you have shown an amazing facility with finances. Was it difficult to get your arms around the accounting issues?

I know everything. I'm one of these people who can sign those statements and feel totally comfortable that I know and am accountable for everything because I do know everything. It has been a pretty interesting experience.

Xerox has been hit in the press and in the stock market because the restatement of revenue was about double what had been expected. Is that reaction fair?

This accounting issue tends to be somewhat miscast. This was all about an accounting methodology that had to do with the timing of revenue, not the authenticity of revenue.

What have you changed at Xerox in light of the questions raised about the company's accounting and management over the past few years?

Historically, we were trying to run the business by product, by industry, by segment, by geography. And when you are into a multidimensional approach, it tends to get a little cloudy as to who is actually responsible. So we did clean up the organizational structure so that everybody sitting at the table has a clear responsibility.

I think that has helped everyone deliver on very concrete, deliverable objectives. And then we have held people accountable, and that is critically important when you're in the midst of a turnaround where you can't afford to waste a lot of time.

“We must... [create] an environment where we can get in front of problems” —

XEROX CEO MULCAHY



Some observers have been questioning whether, as a Xerox insider, you are the right person to turn around the company. Is it hard to make the tough calls, to tell a colleague you have known for years that they're just not measuring up?

I think that in the past two years I have probably made tougher decisions than most CEOs. We have had to shut down businesses, we have taken 22,000 people out of the business. I don't think those are easy choices. I think they're really tough to do, and I don't think I want them to get easy.

What experience have you drawn on the most in the past two years?

Customer focus has to be at the top of the list. Most of my career has been in sales. I spend 50% or more of my time with customers and employees, and I can't wait

for it to be more than 50%.

The SEC ordered you, as part of the settlement, to reevaluate your internal financial controls. What are you doing in that regard?

That's not a new project. Over the last few years there have been a lot of changes. We outsourced internal audit to Ernst & Young to bring in more skills. I do an internal controls review at every operations review I do. We have also done things like a hotline for any kind of issue that popped, and that gets reviewed regularly and also gets reviewed with our audit committee. We do training for our management team on all sorts of ethics and compliance issues.

Xerox has been criticized for having a culture of denial. The SEC criticized the company for a lack of cooperation. Has that culture changed?

When a company goes through a crisis—and we have—it's an opportunity to face problems squarely and address them. We must spend all our time understanding what's not working well, what our customers want to see

from us that they're not getting from us, and creating an environment where we can get in front of problems and not wait for them to become so glaring that we have a crisis on our hands.

Why—in the summer of 2001, when you became CEO—didn't you immediately settle with the SEC?

At that point in time, people were still being subpoenaed, documents were still being subpoenaed. There was all sorts of investigation still going on. It wasn't ready for a conclusion. We reversed the accounting. The bottom line is, it's done, and I don't think it's terribly productive for us at this point to spend a lot of time dissecting the past, either defending the past or, quite frankly, critiquing the past.

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COMPUTERS

WHOSE LUNCH WILL DELL EAT NEXT?

Now, it's moving into printers, storage, and handhelds

Dell Computer Corp. and Hewlett-Packard Co. compete fiercely in the personal-computer market, yet they have had a cozy relationship in printers for the past four years. Dell hawked HP printers and ink cartridges in a deal that generated more than \$100 million a year for HP. But on July 18, Dell said it plans to launch its own line of printers by yearend. Five days later, HP fired off a terse letter to Dell, cutting

off all printer shipments immediately. Dell doesn't care. It's bent on dinging HP's most profitable business—printers.

With rivals back on their heels because of the soft economy, Dell is playing hardball. It's moving aggressively into a broad range of new markets, including printers, handheld computers, storage, and networking gear. And it's swinging for the fences: By 2007, the Austin (Tex.) company wants to double

sales, to \$60 billion, with half of coming from non-PC businesses—pared with a mere 19% of its \$32 billion revenue today.

That's a Texas-size stretch goal, growing the PC business from \$26 billion to \$30 billion over the next five years, reasonable. But to deliver the other \$34 billion in revenues, Dell will have to expand sales in non-PC categories at an average 38% a year. With growth in markets such as printers, computers, and storage slowing, probably to single digits, Dell would have to make its numbers out of the skin of HP, IBM, Sun Microsystems, and Cisco Systems. While its efforts in switches and storage look promising, printers and handheld computers will be the toughest markets to tackle. Add up the numbers, and Dell will have a tough time meeting its \$60 billion target. "Those are imply very aggressive assumptions, particularly in light of mic hardware growth," says Wagonfeld, an analyst at BancAmerica Securities.

Dell's fortunes do look better than its rivals, though. The summer savaging of tech stocks left Dell largely unscathed. Its \$67 billion market capitalization now exceeds those of Oracle, Sun, EMC, and even HP. On July 11, Dell raised revenue and profit projections for the second quarter of fiscal 2003, which ends Aug. 2. Its sales for the period would hit \$8.3 billion, a 9% increase from last year; earnings would be about \$508 million, a 17% jump from last year, excluding a \$742 million restructuring charge.

To rev growth, the 18-year-old company plans to bring the superefficient business model it perfected in the PC business into new markets. The formula is simple: sell directly to customers, cut out costly middlemen, buy components in huge volumes to get the lowest prices, and force suppliers to locate within a few miles of Dell's facilities so parts can be delivered only hours before they're needed. Such supply-chain efficiency allows Dell to radically undercut rivals' prices. The resulting price war sucks profits out of a business until Dell can make money.

It worked like a charm in the server market. When Dell started selling low-end servers in 1996, market leader Compaq Computer Corp. enjoyed gross profit margins north of 40%. Today, they're half that, Compaq is no longer independent, and Dell is the second-largest seller of low-end servers, with 20%

market, compared with 35% for the
 Hewlett-Packard and Compaq.
 Now, Dell is ready to run the same
 in other sectors. *BusinessWeek* has
 ed that on Aug. 12, Dell and part-
 ner EMC Corp. will bring out the first
 in a new family of storage de-
 signed squarely at the slice of the
 ge market dominated by HP. The
 boxes, ranging in price from
 \$100 to \$140,000, will be designed by
 and at least one will be manufac-
 tured by Dell. Analysts say the duo
 slash average storage prices to
 a megabyte, down from 3¢ today.
 The company will feel the pressure
 of Dell's moves more than HP. Since
 the \$1.9 billion acquisition of
 Compaq this year, HP is Dell's
 formidable competitor,
 the largest market share
 in PCs and low-end servers.
 Dell's printing-and-imaging di-
 vision is its cash cow, expected
 record operating profits of
 \$1 billion for fiscal 2002,
 which ends Oct. 31, according
 to Credit Suisse First Boston.
 The profits help HP offset
 losses in PCs, servers, and
 storage, which are expected
 to lose \$1 billion this year.
 Now, Dell is gunning for
 earnings. "There's a
 pool that some of our
 competitors are using to sub-
 vert the PC and server busi-
 ness," Kevin B. Rollins, Dell's
 president and chief operating
 officer, told analysts on July
 10. "That's something we have
 to watch after."
 Dell has reason to worry.
 It takes only a small per-
 centage of the estimated \$600
 billion to \$1 billion in printers
 that it resells yearly for HP,
 Canon International, Canon,
 Epson. That could change,
 however, if Dell sells printers
 under its own brand.
 Though Dell has yet to out-
 line its plans, analyst Charles
 of Needham & Co. says
 Dell is likely to break into the
 business by striking a deal with one of
 its rivals, perhaps Lexmark or Epson.
 Dell would buy printers and cartridges
 from its partner, then start gobbling up
 market share by slashing current prices
 as much as half, starting a price war
 that would puncture the industry's 60%
 profit margins. Dell has plenty of
 room to cut prices. It operates at a lean
 operating expense-to-revenue rate,
 compared with 21% for HP. Dell could
 end up wiping out 25% of HP's printer
 profits, Wolf estimates.
 At first blush, printing would appear

to be a tough market for Dell to crack.
 Getting an existing player to go along
 with a price war could be difficult since
 that would damage its cushy profit mar-
 gins. Distribution also could be a
 headache. Dell's hallmark is direct sales,
 but most printers and ink cartridges
 are sold through dealers and retail
 stores. Meanwhile, HP, which has a 41%
 market share according to Lyra Re-
 search Inc., is in the midst of launching
 50 new ink-jet printers this year, the
 result of \$1.2 billion invested in new
 technology. "We're not sitting here pan-
 icked," says Chris Morgan, vice-presi-
 dent for sales and marketing at HP's
 printing-and-imaging business.

DELL'S INSATIABLE APPETITE

*After gobbling up market share in PCs and servers,
 Dell is moving aggressively into new markets:*

PRINTERS Rival Hewlett-Packard is expected to post
 \$2.8 billion in profits from printers this year, offsetting
 nearly \$1 billion in losses on computers and storage.
 Dell plans to launch a printer line by yearend. If that
 starts a price war, HP's earnings could take a 25% hit.

STORAGE On Aug. 12, Dell will begin selling the first
 member of a new storage line aimed at erasing HP's
 dominance in the market. Analysts say the products,
 which are being designed by storage giant EMC,
 could cut storage prices in half.

NETWORK SWITCHES Last year, Dell sold its
 first low-end switches, which direct traffic on
 computer networks. On June 25, Dell launched more
 robust models that undercut Cisco by 50%.

HOME PCs In 2001, Dell attacked the home PC
 market. By the spring, sales in the U.S. had zoomed
 74%, to \$1 billion. This year, Dell is opening mall
 kiosks where shoppers can see its PCs up close.

HANDHELD COMPUTERS Dell is talking with
 Taiwanese manufacturers about building a handheld
 device it could sell for \$299, or about \$200 less than
 HP's popular iPAQ. That could drive down gross profit
 margins in handhelds, which are over 20%.

Data: Needham & Co., Gartner Group, Credit Suisse First Boston, IDC

Still, Dell holds key advantages. It
 can offer volume discounts on compo-
 nents and expertise in manufacturing
 and distribution that should help it lure
 a manufacturing partner. It also holds
 out the opportunity for huge sales vol-
 ume. "If Dell can compete quality- and
 price-wise with HP, printers will be a
 big hit," says Scott D. Phillips, systems
 administrator at First Magnus Finan-
 cial Corp., a Tucson bank that buys
 servers and switches from Dell. Lex-
 mark and Epson declined comment.

Dell is trying to use its trademark

efficiency to reset the economics of oth-
 er industries. It's pushing into the mar-
 ket for switches, which direct traffic
 on computer networks, putting it on a
 collision course with Cisco Systems Inc.
 and 3Com Corp. Cisco is the behemoth
 of the \$15 billion market, with a 60%
 share. But with the slowing economy,
 customers are more interested in price
 and convenience than whizzy technolo-
 gy, says IDC analyst Jason D. Smolek.
 That gives Dell an opening: After in-
 troducing bare-bones switches last year,
 the company released more sophisti-
 cated switches in June that undercut
 the prices of products from Cisco and
 others by over 50%.

One new market is proving
 ticklish for Dell. The company
 is considering moving into
 handheld computers, where
 Palm Inc. is the top player,
 with a 32% share, and HP is
 second, with 19%. The appeal?
 Gross margins are better than
 20%, nearly twice those of
 PCs, analysts estimate. But
 when Dell approached manu-
 facturers in Taiwan about
 making a device that sells for
 \$299—that's \$200 less than
 the cheapest HP iPAQ—some
 balked, saying that they
 couldn't make a profit at that
 price. Still, analysts think Dell
 may find a partner and offer
 its own device by Christmas.
 "The question is: Do you want
 to be the one who gets the
 volume or not?" says Need-
 ham's Wolf.

Dell isn't slowing down in
 the PC business, either. The
 company, which does 80% of
 its business with corporate
 customers, has long eschewed
 the consumer-PC market. But
 with competitors such as
 Gateway Inc. hurting, Dell is
 going for the jugular. While
 the overall U.S. home PC
 market declined 6% in the
 first quarter, Dell's revenues
 zoomed 74%, to \$1 billion,
 shooting it to No.2 from

No.4, according to IDC. Now, Dell is
 broadening its lineup of ready-built PCs
 and opening kiosks in shopping malls,
 where it can reach consumers face-to-
 face for the first time.

Clearly, Dell thinks this is the time to
 hit its competitors hard. "This is a well-
 thought-out chess game," says Andrew
 J. Neff, senior managing director at
 Bear, Stearns & Co. The question is,
 are Dell's rivals watching the board?

*By Andrew Park in Dallas, with
 Faith Keenan in Boston and Cliff
 Edwards in San Mateo, Calif.*

CEO to-do list

- ☐ The impossible
- ☐ The unpredictable
- ☐ The right thing
- ☐ The next thing
- ☒ Attend BusinessWeek CEO Summit

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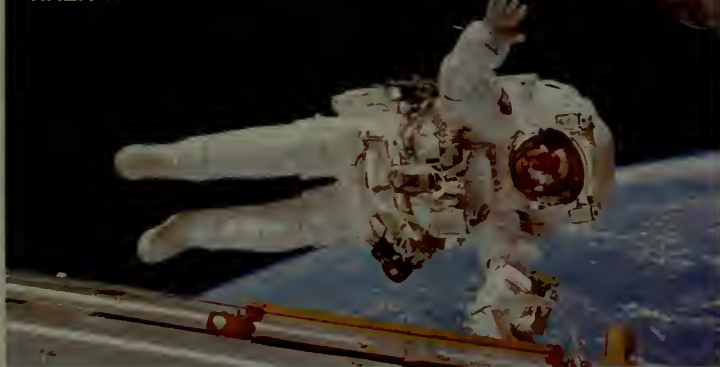
THE UPLIFTING VS ABOUT DEPRESSION

ARED WITH MANY OTHER
ic afflictions, such as di-
s or arthritis, little is
n about the causes and
anisms of brain ailments
as depression and bipo-
isorder. The latter, also
n as manic depressive
s, afflicts more than 2
n American adults and a
ar number of children.
uses debilitating mood
gs marked by euphoria
sphoria, excessive ener-
mpaired judgment, and
sleep.

en before doctors get a
on all aspects of the bi-
t, however, they're push-
head with some promis-
therapies for bipolar
der, many of which in-
off-label uses of existing
ications. At the National
tutes of Health, for ex-
e, Dr. Hussein Manji is
ng at the breast-cancer
ment tamoxifen, which
ves the symptoms of ma-
y inhibiting something
l protein kinase C, a sig-
g pathway within nerve
The Food & Drug Ad-
stration has warned that
xifen might cause uter-
ancer. Still, Manji says, it

important to "test the idea
this is the right target."
ajor drug companies are
g these innovations se-
sly. Eli Lilly, for one, is
ying the atypical anti-
hotic medication olanzap-
sold as Zyprexa, for
lar depression. The hope
at tamoxifen, Zyprexa,
other multipurpose pills
combat at least some
ects of bipolar disorder
er than lithium, which
es about 40% of patients
tremors or other side ef-
s, continued depression,
no relief at all. Within
e to five years, doctors at
NIH hope to have more
rete results on double-
drugs. *Aliya Sternstein*

RADIATION
EXPOSURE
IS A SPACE
HAZARD



WHEN ASTRONAUTS GLOW, TIME TO GO

A MAN IN A WHITE SPACESUIT ADJUSTS HIS HEADPIECE, prompting a laser to scan his retina for molecular sensors just a few billionths of a meter thick. A red light warns that radiation is accumulating in his white blood cells. Maybe it's time for a sojourn on earth.

This isn't Tom Cruise in a summer blockbuster. Within 10 years, NASA astronauts could be using such headgear to monitor their exposure to deadly radiation in space. So says University of Michigan immunologist James R. Baker Jr., whose team has just received a three-year, \$2 million grant from NASA to pursue his invention in collaboration with NanoBio Corp. of Ann Arbor, Mich. Baker's blood sensor consists of polymers called dendrimers, tiny balls just 5 nanometers wide that were designed and synthesized by the team. To these balls, scientists attach fluorescent tags that glow when they are in the presence of proteins from dying cells. Inhaled in a cloud by an astronaut, millions of these molecules would be quickly absorbed by the white blood cells—and would glow when radiation began to kill off the cells. *Aliya Sternstein*

FISH AND CHIPS: HOW TO SAVE A SALMON'S LIFE

WHEN YOUNG SALMON LEAVE their spawning streams for the open sea, they vanish from the prying eyes of science. "We just don't know where they are," says fisheries professor Conrad W. Recksiek at the University of Rhode Island. That's a problem, because many of the small fry perish on their journey to adulthood—and scientists and fishermen would like to know why. "If we knew more about the habitat, it might help prevent mortality," says Godi Fischer, pro-

fessor of electrical and computer engineering at the University of Rhode Island. One question, for instance: Is global warming harming salmon stocks?

That's why Fischer and Recksiek have developed a recording chip, measuring just 2.1 mm by 3.3 mm, to help track the fish. Their first working model combines a tiny temperature sensor with a processor, memory, and battery. The plan is to attach the chips to fish, then read the data years later when the salmon are caught.



SALMON:
A MIDLIFE
CRISIS

INNOVATIONS

■ An honest-to-goodness fat pill may some day be possible, according to a report in the Aug. 2 issue of *Science*. A U.S.-Italian research team led by Dr. Eric S. Bachman at Boston's Beth Israel Deaconess Medical Center has shown, using mice, that an internal furnace can be turned up to burn excess calories by stimulating the nervous system with certain hormones, such as adrenaline. An altered strain of mouse lacking adrenaline receptors quickly plumped up on a high-fat diet. Whether humans can similarly "fight fat with fire" remains to be proved, though. And intriguingly, no one knows for sure where this furnace is located. The candidates include the liver, kidneys, and skeletal muscle.

■ Boeing Co. says it has come up with a wallpaper that beats other materials at suppressing noise on planes. About one-quarter-inch thick, it contains compressed air, which counterbalances the oscillations that make up the low-frequency sounds of jet engines. The compressed air is generated by the aircraft engines, eliminating the need for electric power.

The device will collect a complete record of the water temperatures the fish has swum through. Using temperature readings from the ocean, researchers can roughly chart the fish's wanderings. "The challenge was to make the chip as small as possible and to use very little power," explains Fischer.

Now that the device is working, the scientists have even more ambitious plans, such as adding pressure sensors—or even sonar—to more precisely monitor the piscine journeys.

John Carey

BRANDS

JEEP'S IDENTITY CRISIS

Can it retain a tough image as it expands to a cushier line?

Former Chrysler President Robert A. Lutz was relaxing by a campfire in the Sierra Nevada mountains in the summer of 1988, having just spent a grueling day with Chrysler colleagues driving Jeep Wranglers through the narrow passages and rocky climbs of the legendary Rubicon Trail. Impressed by the Wrangler's performance, an enthusiastic Lutz gushed to his fellow campers: "All Jeep vehicles must be capable of the Rubicon Trail."

And so it was. Since then, every Jeep has been engineered to pass this torture test. Even the swanky, top-of-the-line Jeep Grand Cherokee—nobody's idea of a bare-bones rock crawler—can make the trip, albeit with a few dents and scratches. Jeep's reputation as an authentic mountain machine gave it one of the most crisply defined brands in the automotive business. Trouble is, off-road superiority doesn't count for as much with today's sport-utility buyers, who seem more intrigued by rear-seat entertainment systems and air-cooled upholstery. Now Jeep is faced with a pivotal decision—how can it extend into mainstream SUV territory without losing its rough and tumble image?

The trend has spelled trouble for Chrysler Group, which for years let its most-enduring brand languish while competitors flooded the market with smoother-riding, car-based SUVs. Jeep's share

of the booming SUV market has slipped to 15%, half what it was at its peak in 1993. While it was able at least to hold its unit volume steady for most of that period, lately that's been tanking—by 100,000 vehicles, or 20%, in the past two years, despite the successful launch of the new Jeep Liberty. The brand still represents a hefty one-fifth of Chrysler's sales. But its slide is bleak news for a company whose spectacular 1990s comeback was fueled by consumer enthusiasm for its Jeeps, other trucks, and minivans.

A REAL SLOG AHEAD FOR JEEP

THE CHALLENGE

- ▶ Bolster market share, which has slipped by half
- ▶ Attract more mall drivers with cushier SUVs while staying true to Jeep's image
- ▶ Hold off rugged competitors like GM's Hummer

THE STRATEGY

- ▶ Expand the Jeep lineup at the low and high ends
- ▶ Maintain bad-weather "rescue capability"
- ▶ Position Jeep as an American hero in its marketing

five models, vs. only three for Laments James C. Schroer, Chrysler executive vice-president for global and marketing: "We've got a better brand of SUVs than anybody, but we've got the most limited product line."

Now, finally, more Jeeps are coming to the rescue. Designers are busy naming at least two or three new models for the 2005-2006 time frame. Chrysler expects them to boost Jeep sales to about 700,000, from 455,000 in 2001. But that kind of expansion poses an enormous risk for Jeep. Unless it can find a way to satisfy both trailblazers and suburbanites, growth will slip further. But Jeep runs a risk of losing its core enthusiasts by making SUVs that are too soft. Although only about 25% of all SUV owners ever take their vehicles off-road, Chrysler believes that only 25% of Jeep owners do. "They can't be viewed as too weak or illegitimate," says Christopher W. Cedergren, managing director of Thousand Oaks (Calif.)-based research firm Nextrend Inc.

Some observers wonder why Chrysler took so long to face up to the task. George C. Peterson, president of consultant AutoPacific Group Inc. in Santa Ana, Calif., says it was simply caught flat-footed by the market's change in taste. "It really appears that Chrysler has not chosen, or has not been able to make the kind of product development commitments necessary to keep fully competitive," he says.

Jeep officials insist they are read-

These days, Jeep finds itself sharing the road and off-road alike with a growing crowd of competitors. Consumers have their choice of 57 different SUVs, an array of mostly genteel sport-utes equipped more for the prosaic challenges of navigating suburbia than bouncing over boulders. It's an embarrassment to many inside Chrysler that Toyota Motor Corp.—which didn't even sell SUVs five years ago—today offers



RUBICON ON THE RUBICON:

Old trail, new Wrangler

ff the balancing act. The success of Liberty proves that the nameplate roaden its appeal, they say. While liberty has proven its mettle on Rubicon Trail, it has a softer suson for better on-road handling and proven especially popular with en. Jeffrey Bell, vice-president of a tly created Jeep vehicle brand , sees grounds for hope in the ex- e of a once similarly neglected l, Harley-Davidson Inc. Like Jeep, y was a clearly articulated, Amer- brand that came under attack from n rivals. In response, the company t abandon what Harley-Davidson for," says Bell. "Instead, the com- redoubled its effort."

at's his plan, too. In both its mar- g and new products, Bell says, Jeep stick to its core attributes: au- icity, four-wheel-drive capability, adventure. The \$25,000 Wrangler con, which goes into production lat- us month, fits the bill. The most le of all Jeeps, it comes with front ear locking axles, giant tires, and low gear speeds. It's a strong de- ve move against General Motors , whose new vice-chairman—omi- y, Bob Lutz, who left Chrysler in —plans to attack Jeep's off-road nance with ever-smaller versions Hummer.

here Chrysler's challenge gets ier is stretching Jeep in new di- ons. Chrysler officials say it's no r cast in stone that every Jeep Rubicon capability. Instead, sler now talks about "rescue ca- ity": Jeeps must always be better lping motorists handle severe driv- onditions, like a flooded road or e storm. Chief Executive Dieter che doesn't favor copying the re- trend toward smaller "cute utes" Honda Motor Co.'s CR-V. Instead, pushing for unique vehicles like outhful Jeep Compass, a two-door pt car. But Chrysler insiders say s no agreement on what those vehicles should look like: The Com- , with its aerodynamic, rally-car s? Or more rugged and boxy, like a tional Jeep?

ne option: Do both. For a planned shing of the \$30,000 Grand Chero- n 2005, designers are slathering on e creature comforts one would ex- in a luxury SUV. But company ces say a second, more utilitarian rative is also in the works to satis- eep purists. That way, Chrysler at be able to offer the refinements the increasing ranks of SUV owners e without losing the soul of its most rful brand.

y Joann Muller in Rubicon ngs, Calif.

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UNIONS

BOEING'S HIGH-SPEED FLIGHT

A pivotal fight is brewing over plans to ship more work abroad

After years of mounting conflict with its powerful labor unions, Boeing Co. may be headed for a showdown over the company's aggressive new globalization strategy.

In the past year, the Chicago aerospace giant has laid off nearly 30,000 workers following the September 11 terrorist attacks, which caused many airlines to cancel or delay plane orders. Since then, Boeing has decided that instead of hiring them back as demand for planes picks up, it will shift most of their work—including advanced design and engineering tasks—to lower-cost suppliers in the U.S. and countries such as Russia and China. On July 21, at the Farnborough Air Show in Britain, Boeing commercial airplane unit CEO Alan R. Mulally publicly discussed the company's plans for the first time and said Boeing's two largest unions "are aligned and in tune" with the grim reality that the company will never rehire the 30,000 workers that got laid off.

The reaction was immediate and intense. "We absolutely reject Mr. Mulally's suggestion that Boeing will turn its back on 30,000 loyal employees," retorted Dick Schneider, the chief negotiator for the International Association of Machinists, whose contract covering 26,000 Boeing workers expires on Sept. 1. "If Alan Mulally thinks the IAM is in tune with that idea, he must be tone deaf."

Indeed, Boeing's new strategy runs headlong into the top bargaining priority of the IAM and the 18,000-member Society of Professional Engineering Employees in Aerospace (SPEEA), whose labor pact with

the company expires three months after the machinists'. Both unions have focused on preserving jobs and have called on Boeing to stop sending work to low-wage outposts around the globe. But

Boeing, which has steadily lost market share to archrival Airbus Industrie, determined to slash costs by outsourcing globally. CEO Philip M. Condit sees globalization as a way to both expand to nations that sign on as manufacturing partners and to tap into cheaper markets. "We are an assembler, not a manufacturer," he told reporters in Farnborough. "We will probably [make final assembly] in parts, which are most efficiently made by people who focus on doing that."

And so, as the IAM and Boeing enter the final month of bargaining before the contract expires, a potentially pivotal battle is shaping up over whether the company will remain primarily

U.S.-based enterprise. Boeing has been relatively slow to shift production and design work abroad, though it has stepped up the pace in recent years (table). If it uses the window of opportunity opened by the layoffs, Boeing could be transformed into a global enterprise that is much less dependent on U.S. for both brawn and brains. Boeing's unions, however, hope to persuade Condit to compete against more efficient Airbus by boosting productivity of its U.S. workers. "We're looking at labor partners at creating value, not adversaries who will be taking over an ever-shrinking pie," warns IAM strategy director Steve Shuman.

Boeing and its unions have long struggled with the effects of outsourcing, both in the U.S. and overseas. It played a big part in the IAM's 1995 strike, in 1995. To settle the 69-day brawl, Boeing agreed to allow the union to trim jobs to retain jobs in-house, matching the costs of suppliers bidding on work to be outsourced. The two sides averted another walkout in 1999 over the IAM's effort to strengthen the process. In the end, Boeing agreed to limited guarantees against outsourcing layoffs.

This time, the IAM wants a commitment in the contract specifying machinist employment levels, similar provisions in IAM and UAW Auto Workers contracts with Detroit carmakers.

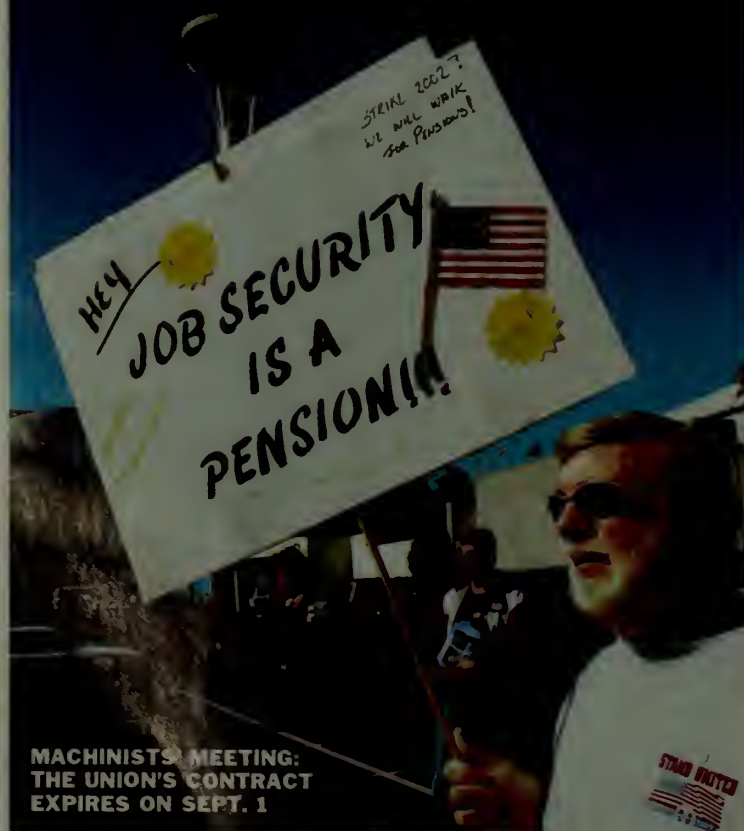
The machinists argue

IT'S NOT JUST THE SMALL STUFF

The planemaker says it won't rehire 30,000 laid-off workers, and it will base more engineering and design work overseas. Some moves it has already made:

- ▶ Its Moscow Design Center employs 500 engineers and technicians who design parts for the 777 and other commercial jetliners
- ▶ Xian Aircraft in central China builds tail sections for the 737
- ▶ Poland's WZK-Mielec makes aircraft doors for the 757
- ▶ Shanghai Aircraft manufactures components for several Boeing planes
- ▶ Mexmil in Mexicali, Mexico, makes fuselage-insulation blankets for all of Boeing's commercial planes

Data: BusinessWeek



Sports Business



GOLF

MORE HEAT ON THE MASTERS

Now corporate sponsors are being asked to take a stand

The very public feud between a powerful women's organization and the men-only Augusta National Golf Club—home of the storied Masters Tournament—now threatens to draw in some of the biggest names in Corporate America. There is talk of national boycotts. And Masters sponsors such as Coca-Cola and Citigroup—whose chairman, Sanford I. Weill, is a member of Augusta—are being asked to take a stand. Even Tiger Woods is being criticized for suggesting that Augusta has a right to its exclusionary policies.

The fight began in mid-July, when Martha Burk, chairwoman of the National Council of Women's Organizations (NCWO), sent a private letter to William W. "Hootie" Johnson, chairman of Augusta, urging him to open the club to female membership before the 2003 Masters. Johnson's five-line response said that "further communication between us would not be productive." And he loudly and emphatically separated the Masters, a public tournament, from Augusta National, a private club.

While private clubs can admit or not admit anyone they want, counters Burk, Augusta, which owns the Masters, "has built a unique image with huge public exposure, and with that comes a higher responsibility...."

Now Burk has written to sponsors of the Masters—Citigroup, Coca-Cola,

IBM, and General Motors—asking them to withdraw their support until Augusta opens its doors. If the NCWO does not get a positive response by mid-September, it is prepared to boycott company products and picket the tournament.

What impact would a continued NCWO campaign have? The NCWO, which represents 160 organizations with some 6 million members, has a long history of effecting social change. Despite that and despite the hammering that Johnson has suffered in the press, it's tough to say whether Augusta will bend. Corporations consider it a privilege to sponsor the Masters, and lots of business is done at the event. In fact, the Masters might not even need sponsors. Still, "this could be a very flammable situation" if consumers perceive that these companies are discriminatory, says sports marketing consultant Jeff Bliss of Javelin Group in Alexandria, Va.

Albert J. Tortorella, a crisis-management specialist at public-relations firm Burson-Marsteller, is more sanguine. It's hard to sustain public interest in a debate when one side is talking and the other isn't, he says.

If the campaign to open Augusta's doors gains momentum, however, the pressure will build. Says former LPGA champ Jane Blalock: "The players could do more. And Tiger could do more. But you don't want to always put the burden on Tiger. The PGA Tour as a whole should take a stand on this."

In the end, sponsors of the Masters may have to choose between prestige golf and the people who purchase more than 80% of consumer products: women. With corporate scandals continuing to rock America, that's a problem these public companies don't need.

By Toddi Gutner, with Mark Hyman

HOOTIE AND THE TIGER:
Johnson and Woods in '02

ization is ultimately a self-defeating strategy for Boeing. They maintain that much work is handed off to suppliers—it would drain the company of skills and sap its control of the processes that create added value. Schneider also points out that Boeing spent \$10 billion on share repurchases since 1997. That's the price tag of a plane model—and Airbus has done nothing but upgrade its 777. While Boeing is giving money back to investors, Airbus is ensuring that it dominate market share in years to come, says Schneider. Boeing has extended the repurchases as a way to lift stock price.

Surprisingly, labor's position has some support within management's ranks. A number of executives are concerned that aggressive outsourcing could lead to a shortage of cash flow needed to develop new planes. Last year, for example, Boeing senior scientist L.J. Hart-Smith presented a controversial paper making the argument to Boeing senior executives. Ironically entitled "Outsourced as The Cornerstone of Successful Contracting," it said that too much outsourcing diverted profits to suppliers and led to the downfall of the once-dominant McDonnell Douglas Corp., which Boeing acquired in 1997.

While top Boeing officials declined comment for this article, they have admitted that the advantages of global sourcing—lower costs and higher margins—outweigh potential drawbacks. Last year, Condit appointed former Mexican ambassador to the U.N. Carlos Pickering to be Senior Vice President of International Relations. Pickering has been scouring the globe for companies that he calls "strategic partners"—government-owned aerospace companies that will agree to purchase Boeing aircraft in exchange for production and design work being located in those countries.

It's no longer just blue-collar factories, as SPEEA has discovered. Boeing has opened aircraft-design centers in Spain, Italy, and Moscow, with more in the works. Its 500-plus Russian engineers make about \$10,000 a year, \$2,000 for SPEEA members. Fumes from Boeing Executive Director Charles Boffey: "They have to stop boxing up work and sending it to Moscow." Right now, Boeing seems unlikely to capitulate to the kind of employment demands its unions desire. But that could change if the possibility of a walkout seems larger. Given workers' strong opinions on this issue, management may want to brace itself for a bumpy ride.

Stanley Holmes in Farnborough, England

TOUGH YEAR, SMART CALLS

Gene Marcial beat the averages hands down in his weekly column of stock market picks

Finding stocks that go up in a bear market is never easy. Last year, it was a nightmare. The tech wipe-out dragged the U.S. into recession. Then came the September 11 attacks and the unfolding Enron Corp. scandal. Nonetheless, Gene G. Marcial, who writes *BusinessWeek's* Inside Wall Street column, managed to uncover an array of stocks that produced positive returns—in contrast to most major indexes, which plunged in 2001. The Nasdaq Composite index was down 20.8%, the Standard & Poor's 500-stock index fell 11.9%, and the Dow Jones industrial average was off 5.9%. And they kept dropping in 2002.

The gainers weren't just one-day wonders that rose as readers bought on the column's advice. (They first appear on *BusinessWeek's* Web site after Thursday's market close.) Share prices of 116 companies—70% of the 166 that Inside Wall Street featured in 2001—rose the day after they were mentioned. And six months later, 86, or more than half, were ahead—some spectacularly so.

The stocks mentioned in Inside Wall Street are no substitute for a diversified, buy-and-hold portfolio. They're mostly short- to mid-term buying opportunities. Marcial, who has covered the market since 1981, ferrets out the buzz on companies that could signal an upturn for their stock—a

merger, an improving balance sheet, or new products.

The column covered a wide range of companies, from IBM to little-known up-and-comers. His biggest winners over six months were volatile small stocks: All seven that rose 100% or more had market caps of less than \$1 billion. As did the losers: Of the 11 that sank 50% or more, nine were small outfits.

The best performer was tiny Singing Machine Co. in Coconut Creek, Fla., which makes karaoke machines for home use. Shares jumped 284.4%, from \$4.01, in the six months after Marcial mentioned the company in the Oct. 8 issue. An unnamed New York money manager who was buying said Singing Machine should gain because families would seek fun at home after September 11. In the nine months ending Dec. 31, 2001, the company's net income rose 144% year-on-year, to \$8.27 million, and revenues rose 80%, to \$55.4 million.

To gauge the column's performance, *BusinessWeek* tracks the stocks for six

months after they're featured. That's why we wait until now to publish last year's results. We look at one-day, one-month, three-month, and six-month returns for each stock as well as the average and median performance for those periods. Then we compare them with the major market benchmarks.

For every period, the column beat the indexes (table). The first trading day after they were mentioned, the stocks gained an average of 3.1%. By contrast, the major indexes fell on average on a one-day basis. Yet, so powerful is this bear market that the column's average one-day gain was the lowest in the five years we've measured performance. Between 1997 and 2000, average first-day gains ranged from 4.7% to 8.8%.

The stocks rose a bit more over time. On average, they were up 4.2% after one month, 6.1% after three months and 6.4% after six months. In contrast, the Wilshire 5000 index was down on average over six months. Inside Street even beat the average 1.2% for the Russell 2000 index of small stocks over six months.

Averages are only one measure. The column produced some huge wins along with some amazing losers, which skewed the averages. To factor out distortion, we looked at the median-point where half the returns were higher and half were lower. By that measure, the one-month return, 5.4%, stood out. After that, returns trailed off. The three-month median return was 2

TAKING ON THE INDEXES

Inside Wall Street featured 166 stocks in 51 issues of the magazine in 2001. For each issue, the comparable returns for the market benchmarks were calculated for each of four time periods. The returns were averaged over all the issues, and the results are given below. The average return for the column was figured in the same way

	1 Day	1 Mo.	3 Mos.	6 Mos.
INSIDE WALL STREET	3.1%	4.2%	6.1%	6.4%
STANDARD & POOR'S 500	-0.3	-0.8	-2.9	-6.1
DOW JONES INDUSTRIALS	-0.2	-0.1	-0.8	-2.3
NASDAQ COMPOSITE	-0.5	-1.2	-4.6	-10.1
WILSHIRE 5000	-0.2	-0.7	-2.5	-5.1
RUSSELL 2000	-0.1	0.6	0.7	1.2

Data: *BusinessWeek*, Standard & Poor's

Sweet contrarian pick: Krispy Kreme Doughnuts



THE BEST PERFORMERS...

FOR ONE DAY	
COMPANY/SYMBOL	GAIN/LOSS
ORCHIO BIOSCIENCE ORCH	37.4%
DISCOVERY PARTNERS INT'L DPII	31.7
COMPUOYNE CDCY	31.2

FOR ONE MONTH	
VYSIS VYSI	60.6%
NET2PHONE NTOP	57.3
INPRISE INPR	57.3

FOR THREE MONTHS	
SINGING MACHINE SMD	296.8%
VYSIS VYSI	253.9
HOTJOBS.COM HOTJ	162.2

FOR SIX MONTHS	
SINGING MACHINE SMD	284.4%
VYSIS VYSI	157.8
CUBIC CUB	135.4

...AND THE WORST

FOR ONE DAY	
ASIA GLOBAL CROSSING AGCX	-8.3%
CALIPER TECHNOLOGY CALP	-6.8
SABA SOFTWARE SABA	-6.1

FOR ONE MONTH	
PENN TREATY PTA	-82.0%
INFOSPACE INSP	-58.3
BROAOCOM BRCM	-48.1

FOR THREE MONTHS	
ACLN ASW	-82.6%
PENN TREATY PTA	-78.6
INFOSPACE INSP	-65.2

FOR SIX MONTHS	
ACLN ASW	-93.1%
REOBACK NETWORKS RBAK	-85.6
PENN TREATY PTA	-85.0

Data: Bloomberg Financial Markets, *BusinessWeek*

growth projections from investment strategist Bernie Schaeffer and J.P. Morgan Chase & Co. analyst John Ivankoe. The stock doubled in six months.

The column had its share of off-base calls. One of its biggest misses was Cyprus used-car dealer ACLN Ltd, which was featured in the Oct. 22 issue. Marcial wrote about ACLN in May, 2000, and it rose 46% over six months. This time around, he quoted David Jordon of Axiom Capital Management and Gregory Burns of J.P. Morgan Securities Inc. as saying ACLN was undervalued. Then questions about its financials and other concerns emerged. The New York Stock Exchange delisted ACLN in April, 2002. Six months after it was featured, investors had lost 93.1% of their money.

Another flawed call was Penn Treaty American Corp. The insurer was flagged as a takeover candidate in the Mar. 26 issue. But the stock fell 82% three weeks after the column appeared. The reason? In an Apr. 2 Securities & Exchange Commission filing, Penn said that auditors questioned its survival. No deal occurred, and the shares haven't recovered.

Inside Wall Street's call on Excite@Home in the Jan. 29 issue was also unserendipitous. The Internet company's shares had fallen to \$8.31 from a high of \$95 in 1999 when Joan Lappin, president of Gramercy Capital Management, called the company a top pick. Its main shareholder, AT&T, had agreed to buy the 16% it didn't own for \$2.9 billion, almost Excite's entire market value. By April, however, Excite was in trouble, and AT&T dropped its support. Excite filed for bankruptcy in September.

Timing is everything. Marcial's June 11 column singled out once-promising drug company ImClone Systems Inc. long before then-CEO Samuel D. Waksal was

six months, it had slipped to 0.8%. Inside dope on takeovers is one of the column's specialties. But last year, merger activity dried up, there were fewer bets to make on corporate nuptials, or 33, of the companies were picked as merger prospects in 2001. Of those, 21%, tied the knot, including Conoco, Dreyer's Grand Ice Cream, Pennzoil-Quaker State, HotJobs. In contrast, 30% were picked on the cover talk in 2000—though the percentage that did the deed was basically the same, 20%.

Of this year's takeovers, Vysis, which develops DNA-based tests for cancer, wasn't on Marcial's list when he

recommended it at \$7.94 in the Apr. 16 issue, but it proved a winner, rising to \$20.47, a gain of 157.8% over six months. Ron Opel, a health-care analyst at Boston brokerage H.C. Wainwright & Co. and Carl L. Gordon, a partner at OrbiMed Advisors LLC, a health-care investment firm, predicted Vysis would get government approval for a test. Ultimately, Abbott Laboratories bought it in December for \$30.50.

In a brutal market for pricey stocks, the column made a sweet contrarian call. Last April, Krispy Kreme Doughnuts Inc., which traded close to 52 times earnings, was a short-sellers' favorite. But Marcial called it a buy, citing

ite of the shorts, but Marcial spotted it as a buy

charged with illegal trading on nonpublic information about drug-approval problems. Six months after the column appeared, the stock hit \$72—up 45% from its level on the day before publication. But two weeks later, on Dec. 28, Imclone revealed its regulatory woes. The shares plunged. They closed at \$7.11 on July 31.

Still, past scandals can be next year's turnaround stories. That was the Mar. 12 column's call on Cendant Corp., whose 1998 accounting scandal foreshadowed today's earnings revelations. Cendant gained 46% over six months.

In a market that proved to have so many disasters-in-waiting, Marcial's on-

the-money calls outweighed the m. Can he keep it up? The market w a minefield as more corporate sca emerge and the urge to purge gains strength. Stay tuned.

By Geoffrey Smith in Boston
Michael J. Mandel, Robert J. R
berg, and Sarah B. Davis in New

THE INSIDE WALL STREET SCORECARD

Here are the 166 stocks featured in Inside Wall Street during 2001. For each stock, we give the last closing price before the column became public, usually a Thursday. Then we compute the one-day, one-month, three-month and six-month percentage returns. When any of those periods ends on a weekend, the prior Friday's

closing price is used. When a company is taken over within six months, we calculate prices up to the merer's effective date. Because the market was closed from Sept. 11-20, the returns for each period were adjusted accordingly beginning Sept. 21. The Thursday close is 11 days before the issue date.

COMPANY NAME/ STOCK SYMBOL	THURSDAY CLOSE	PERCENT GAIN				ISSUE DATE
		1 DAY	1 MO.	3 MO.	6 MO.	
CONCEPTUS CPTS	\$10.13	8.64%	44.60%	-6.17%	38.67%	1/08
SMART & FINAL SMF	8.13	0.71	14.54	28.54%	35.30	1/08
SABA SOFTWARE SABA	16.50	-6.06	-1.52	-52.24	-23.21	1/08
OSI PHARMACEUT. OSIP	62.50	1.90	-0.30	-45.70	-15.60	1/15
PIONEER STANDARD OIOS	12.19	2.56	19.49	-15.38	-1.13	1/15
LINCOLN NATIONAL LNC	42.94	-1.75	5.48	-1.28	20.87	1/15
INHALE THERAPEUTIC INHL	31.00	6.25	-3.02	-22.90	-33.90	1/22
INPRISE ¹ INPR	6.59	7.11	57.34	11.17	112.02	1/22
GEHL GEHL	14.25	3.07	5.26	-0.35	26.67	1/22
EXCITE@HOME ² ATHM	8.31	4.51	-29.14	-48.51	-73.17	1/29
INFOSPACE INSP	8.69	2.52	-58.27	-65.24	-61.67	1/29
VOLT INFO. SC. VOL	22.63	11.33	9.04	-23.89	-24.73	1/29
TAKE-TWO INERAC. TTWO	11.81	5.82	0.52	14.45	68.97	1/29
BAUSCH & LOMB BOL	43.06	6.53	17.97	-2.93	-22.58	2/05
ANDRX ADRX	68.88	1.54	-17.51	-26.68	-7.47	2/05
ASIA GLOBAL CROSSING ³ AGCX	9.00	-8.33	-19.44	-31.67	-38.78	2/05
CLOROX CLX	35.75	-2.74	-2.01	-9.68	2.24	2/12
EXELON EXC	60.68	0.76	8.06	14.32	-5.03	2/12
ACACIA RESEARCH ACRI	16.71	-4.08	-42.18	-35.29	-7.65	2/12
BOSTON SCIENTIFIC BSX	15.99	-0.56	11.13	-2.88	14.32	2/19
DEERE DE	42.24	1.40	8.69	-4.66	-3.81	2/19
ADOBE SYSTEMS ADBE	35.94	-1.57	-24.52	17.03	-5.23	2/19
AOL TIME WARNER AOL	48.76	-3.10	-8.74	6.50	-7.55	2/19
BROADCOM BRCM	78.88	-2.14	-48.10	-43.54	-45.75	2/19
INT'L BUSINESS M. IBM	114.10	-1.84	-6.69	3.16	-8.69	2/19
UNISYS UIS	18.47	2.38	-20.84	-35.03	-36.98	2/26
NAUTICA ENTERP. NAUT	18.00	2.08	-6.94	0.28	-22.22	2/26
MAXYGEN MAXY	18.50	-0.68	-32.43	-18.05	-24.32	2/26
REOBACK NETW. RBAK	29.94	16.07	-39.31	-42.18	-85.64	3/05
AMER. STANDARD ASD	54.68	-0.38	-1.08	19.15	22.77	3/05
FRONTIER OIL FTO	7.75	5.81	-4.26	55.48	100.00	3/05
PARK ELECTROCH. PKE	29.25	-4.62	-22.74	-24.79	-14.36	3/12
THERMO ELECT. TMO	23.46	-0.30	-17.35	3.15	-17.39	3/12
CENDANT CD	13.10	0.99	11.37	44.89	45.57	3/12
APPLE COMPUTER AAPL	20.81	-2.69	-1.06	2.45	-16.96	3/19
EARTHLINK NETW. ELNK	10.06	-1.79	12.43	43.44	39.17	3/19
NCO GROUP NCOG	33.50	-0.75	-20.51	-2.63	-40.87	3/19

COMPANY NAME/ STOCK SYMBOL	THURSDAY CLOSE	PERCENT GAIN			
		1 DAY	1 MO.	3 MO.	6 MO.
IKON OFF. COL. SOL. IKN	\$5.15	7.38%	-1.36%	65.05%	63.11%
QUEST DIAGNOSTICS ⁴ DGX	42.29	-0.97	13.27	48.95	39.13
ELAN ELN	49.26	0.51	6.31	23.73	2.42
PFIZER PFE	38.55	-3.06	6.10	10.58	-1.06
PENN TREATY PTA	16.70	11.74	-82.04	-78.56	-85.03
REGIS RGIS	15.31	2.74	1.31	26.45	33.90
SMITHFIELD FOODS ⁵ SFD	16.13	7.81	13.45	13.33	27.71
JOHN HANCOCK FI. JHF	33.85	4.46	4.43	16.63	1.74
GENERAL MOTORS GM	52.30	-0.33	8.49	20.19	-23.04
AMERICAN EXPRE. AXP	38.96	6.01	12.27	-0.41	-25.41
STONE ENERGY SGY	47.75	3.18	5.70	-7.23	-32.57
SERVICE CORP.M. SRV	4.34	9.45	7.14	46.54	38.71
ALLIANCE CAP MA AC	41.20	1.92	18.57	29.00	13.83
BIOMIRA BIOM	6.00	12.00	40.17	19.00	-14.17
VYSIS ⁶ VYSI	7.94	11.84	60.58	253.90	157.81
KRISPY KREME ⁷ KKD	18.02	0.17	36.51	96.45	99.67
CHURCHILL DOWNS CHDN	29.95	1.00	1.10	-10.85	-11.19
AUTODESK ⁸ ADSK	15.61	-0.26	12.88	24.28	14.54
ELECTRONIC ARTS ERTS	60.16	-5.60	-1.50	-6.63	-11.25
CARDINAL HEALTH CAH	63.67	0.63	9.53	13.98	17.79
APACHE APA	55.55	-0.63	5.40	-23.91	-21.37
PENNZOIL-QUAKER PZL	13.95	1.51	12.04	-18.49	-10.25
VIACOM VIA	53.11	-2.86	9.58	-5.86	-29.81
HOTJOBS.COM ⁹ HOTJ	4.10	9.27	48.05	162.20	58.29
FURNITURE BRAN. FBN	23.78	1.77	-1.26	22.08	4.96
JONES APPAREL JNY	43.27	1.48	5.57	-21.08	-36.10
HOLLYWOOD MEDIA HOLL	4.80	16.67	-15.21	0.00	-36.88
SCHERING-PLOUGH SGP	37.10	3.23	14.12	3.50	-4.10
CHILDREN'S PLACE PLCE	28.58	1.47	-4.83	-10.43	-9.66
AOL TIME WARNER AOL	52.45	-1.54	-2.67	-15.54	-29.27
LIBERTY MEDIA ¹⁰ LMG/A	16.25	-2.77	1.11	-0.92	-23.69
CALIPER TECHN. CALP	28.00	-6.79	-26.36	-46.96	-53.36
NORTH FORK BANC. NFB	27.75	-0.07	3.64	17.48	5.12
VECTOR GROUP VGR	34.67	1.62	-10.33	-4.85	23.45
TRITON PCS HOLD. ¹¹ TPCS	36.30	1.49	-1.96	4.68	-12.53
SCIOS ¹² SCIO	24.56	2.65	-10.02	-18.36	12.58
QUEST SOFTWARE QSFT	35.42	2.00	-2.80	-46.92	-38.85

NY NAME/ SYMBOL	THURSDAY CLDSE	PERCENT GAIN				ISSUE DATE
		1 DAY	1 MO.	3 MO.	6 MO.	
FTWARE MNS	\$18.40	4.95%	-6.25%	7.07%	-27.17%	6/04
ME TECH IGT	61.45	3.11	2.12	-12.90	0.88	6/11
SYSTEMS IMCL	49.65	6.93	6.34	3.52	45.02	6/11
EX 3 IFMX	4.70	7.23	24.26	0.43	-12.34	6/11
LTR	64.45	1.49	-4.36	-24.36	-13.72	6/18
PARFUMS ¹⁴ IPAR	8.00	7.13	16.63	11.25	-6.25	6/18
BROADC. SBGI	9.11	6.59	15.15	8.34	-0.11	6/18
	37.50	3.97	2.69	-20.00	-47.07	6/25
ON ORGANIC HCOW	8.05	3.73	27.33	22.36	103.48	6/25
EDIA INT'L MMG	2.84	5.63	-17.25	-38.38	-68.66	6/25
LAT	58.03	-0.69	6.84	-4.79	6.50	7/02
E MINI MINI	29.83	-0.87	12.71	-12.74	17.57	7/02
ESORTS RST	14.36	-1.04	-8.08	-37.33	-12.95	7/02
AY GOLF ELY	16.25	-2.77	-3.26	-21.23	20.62	7/09
IMMUNOTH. AVAN	4.90	15.31	3.47	-51.63	-18.57	7/09
NE ABF	11.25	3.02	4.89	-15.11	33.07	7/09
R COS. COO	47.95	3.02	2.19	1.23	-3.13	7/16
TERPRISES AFCE	19.90	3.57	11.11	11.61	42.26	7/16
TATE BAKE. IBC	17.28	18.92	32.00	40.05	44.16	7/16
ENERGY OEI	17.70	7.68	9.55	0.85	-3.67	7/23
GREETINGS AM	11.11	0.36	2.88	31.68	38.43	7/23
HARMACEU. TEVA	63.34	0.76	5.94	5.30	-1.88	7/23
R ANTHONY ¹⁵ TA	26.30	-1.71	-10.04	n/a	n/a	7/31
FINANCIAL TSFG	19.14	-0.78	3.81	-16.93	-7.99	7/31
CE GAMING ¹⁶ ALLY	8.18	-0.98	11.37	-2.20	94.13	7/31
TEC THOR	18.15	0.06	6.89	6.89	-1.93	8/06
T TRADING NITE	10.30	3.79	9.42	6.31	6.50	8/06
FAMILY ST. ¹⁷ RYAN	10.16	2.82	10.90	18.44	50.59	8/06
OLOGIC CRYP	28.70	1.57	-23.69	-49.30	-56.86	8/13
VI	24.56	0.04	7.08	-20.36	2.77	8/13
T SYSTEMS ANS	7.43	5.52	-13.19	-15.21	9.83	8/13
NET. ¹⁸ NCAR	12.00	4.17	24.00	-25.42	-40.50	8/27
R'S GRANO DRYR	27.88	0.43	7.46	20.70	41.64	8/27
Y DAVIDSON HDI	50.20	-1.41	-12.49	-7.65	5.78	8/27
TAR COMM. DISH	27.72	4.37	-20.92	-9.78	-17.39	9/03
FINANCIAL DORL	35.49	-4.99	-10.82	-5.27	-5.86	9/03
R CARE RHB	35.98	14.48	3.11	-28.40	-38.02	9/03
LOINGS IPCR	23.42	2.86	-2.65	11.44	30.79	9/10
T FON	22.82	2.28	5.21	-4.51	-34.49	9/10
GEN CGEN	3.95	4.30	-24.56	-20.00	-14.68	9/10
BOSTON FIN. FBF	35.56	-2.53	-5.37	5.60	0.82	9/17
LASTIC SCHL	39.06	-0.10	18.82	14.57	28.52	9/17
CO ¹⁹ COC.B	31.06	-0.29	-15.65	-13.88	-9.53	9/17
R HOLDINGS AH	19.92	0.40	22.79	34.79	20.13	9/24
LI-CHECK IDN	10.96	-4.65	22.72	68.34	26.82	9/24
JR GROUP VGR	\$39.00	0.85	10.96	-14.74	-25.66	9/24

COMPANY NAME/ STOCK SYMBOL	THURSDAY CLDSE	PERCENT GAIN				ISSUE DATE
		1 DAY	1 MO.	3 MO.	6 MO.	
TITAN TTN	\$17.17	1.98%	7.69%	46.83%	18.23%	10/01
CENTRA SOFTWARE CTRA	10.55	-5.69	-44.08	-23.61	-53.36	10/01
COMPUPLYNE CDCY	12.35	31.17	8.91	20.32	5.64	10/01
MARSH&MCLENANN ²⁰ MMC	93.70	3.20	10.74	14.46	20.32	10/08
HILB ROGAL&HAM ²¹ HRH	21.75	4.87	39.34	29.68	42.33	10/08
ARTHUR J. GALLAG. AJG	33.70	0.45	12.52	3.80	-2.52	10/08
BROWN&BROWN ²² BRO	24.95	4.41	19.84	11.06	22.57	10/08
WILLIS GROUP HO. WSH	23.95	-2.34	4.47	-3.34	3.13	10/08
CROSSMANN COMM. CROS	22.20	18.33	19.14	48.29	103.87	10/08
SINGING MACHINE ²⁴ SMD	4.01	9.82	55.74	296.84	284.36	10/08
CHOLESTEC CTEC	18.00	3.22	16.33	3.39	2.50	10/15
ELCOR ELK	21.13	0.47	11.03	26.98	2.98	10/15
CHICO'S ²⁵ CHS	20.43	-2.45	-15.82	37.68	60.62	10/15
ACLN ²⁶ ASW	39.05	-3.33	-31.11	-82.59	-93.09	10/22
ORCHIO BIOSCIENCE ORCH	3.10	37.42	13.55	61.94	-27.74	10/22
GRIFFON GFF	11.05	5.34	16.74	30.59	73.85	10/22
COR THERAPEUTICS ²⁷ CORR	21.30	-2.35	-1.60	-5.77	6.43	10/29
MIKOHN GAMING MIKN	4.88	11.68	44.88	85.45	42.42	10/29
LA QUINTA LQI	4.93	5.07	11.16	38.95	56.39	10/29
THERMO ELECTRON TMO	18.52	7.49	20.00	22.06	3.42	11/05
NET2PHONE NTOP	4.12	12.62	57.28	22.33	22.57	11/05
AVANT IMMUNOTH. AVAN	3.94	5.58	-17.51	-18.78	-50.00	11/05
UNIVERSAL AMER. UHCO	6.50	-2.31	9.08	-3.85	17.83	11/12
VERMONT PURE HO. VPS	3.65	6.58	31.51	41.10	30.14	11/12
CIPHERGEN BIOSY. CIPH	5.15	-2.33	0.00	35.34	26.99	11/12
UNIVISION UVN	30.30	4.49	28.32	32.61	38.84	11/19
CUBIC ²⁸ CUB	12.23	7.39	2.51	33.52	135.43	11/19
MULTIMEDIA GAMES ²⁹ GAM	17.60	2.09	45.95	48.30	58.52	11/19
COI CDI	17.10	2.05	17.84	26.67	70.18	11/26
PANERA BREAD PNRA ³⁰	47.10	0.32	4.71	19.98	45.31	11/26
GENENTECH DNA	55.45	-0.29	-4.78	-10.71	-32.01	11/26
CABLEVISION SYS. CVC	37.80	1.88	18.65	-11.67	-44.58	12/03
J.P. MORGAN CHAS JPM	38.84	1.42	-7.96	-24.97	-3.40	12/03
EDGAR ONLINE EDGR	2.69	13.01	15.24	5.24	15.24	12/03
CV THERAPEUTICS CVTX	53.90	2.32	-0.41	-27.55	-64.29	12/10
MCSI MCSI	20.65	0.48	11.77	-48.91	-37.00	12/10
DISCOVERY PART. DPII	5.30	31.70	33.02	13.21	10.38	12/10
TAKE-TWO INTERAC. TTWO	14.28	2.38	31.65	39.36	78.57	12/17
GLOBAL SANTAFE GSF	24.37	1.35	12.35	24.13	25.44	12/17
REGISTER.COM RCOM	10.22	9.00	5.38	-11.15	-23.09	12/17
IMPAX LABS IPXL	11.97	5.68	9.86	-40.52	-35.25	12/24
COUNTRYWIDE CCR	40.49	2.05	-0.59	7.43	13.41	12/24
KEY ENERGY KEG	8.40	-3.57	-6.55	26.19	17.86	12/24
EBAY EBAY	63.59	2.20	-5.36	-11.39	-5.00	12/31
US ONCOLOGY USON	7.53	2.66	11.55	6.24	17.53	12/31
ACACIA RESEARCH ACRI	9.80	5.61	14.29	3.06	-30.10	12/31

ange to Borland Software Corp., BORI, 1/22/01
 bol change to ATHMQ; Delisted from OTCBB, 6/4/02
 bol change to ASGXF, 02/28/02
 t 2 for 1, 6/1/01
 t 2 for 1, 9/17/01
 rred by Abbott Laboratories, 12/5/01
 bol change to KDD, 5/17/01
 t 2 for 1, 4/19/02
 rred by Yahoo Inc., delisted 2/13
 t 2 for 1, 3/20/01 and 6/15/01.
 ange to Liberty Media Corp., L, 8/10/01

11. Moved to NYSE; Symbol change to TPC, 7/31/01
 12. Trading halted 5/25/01 pending FDA drug approval
 13. Change to Ascential Software Corp., ASCL, 7/3/01
 14. Split 3 for 2, 9/17/01
 15. Acquired by Royal Bank of Canada, 11/1/01
 16. Split 2 for 1, 4/9/02 and 8/21/01
 17. Split 3 for 2, 5/30/02
 18. Change to Quovadx Inc., QVDX, 10/1/01
 19. Reclassified into common shares;
 Symbol change to COC, 10/8/01
 20. Split 2 for 1, 7/1/02

21. Split 2 for 1, 1/2/02
 22. Split 2 for 2, 11/23/01
 23. Acquired by Beazer Homes USA Inc, 4/18/02
 24. Split 3 for 2, 3/18/02
 25. Split 3 for 2, 1/22/02
 26. Symbol change to ACLNF, 4/2/02
 27. Acquired by Millennium Pharmaceuticals, 2/13/02
 28. Split 3 for 1, 5/1/02
 29. Split 3 for 2, 2/12/02
 30. Split 2 for 1, 6/25/02

Corporate Scoreboard



DON'T GET YOUR HOPES UP—YET

Earnings are a bit better, but real improvement is down the road

This was supposed to be the season of celebration—a time when buoyant corporate profits would finally prompt pessimists to recognize that recovery was well under way. But even with an 8% jump in second-quarter earnings from the year before, a specter of misery con-

tinues to loom over the 900 companies on *BusinessWeek's* Corporate Scoreboard. That growth comes off a notably weak 2001 period that had been marked by a 52% plunge in profits. Meanwhile, second-quarter sales managed only an anemic 1% increase, year to year.

The soft top-line growth suggests

that companies are managing to squeeze out gains mostly by keeping costs down. Margins rose to 4.4%, from 4.1% a year before, and average wage growth slowed significantly in the first half of 2002 to nearly flat levels. Indeed, growth may even drop into negative territory if unemployment starts to

Winners and Losers in Quarterly Profits

INDUSTRIES

COMPANIES

LEADERS		LAGGARDS		WHO MADE THE MOST		WHO LOST THE MOST	
PERCENTAGE CHANGE FROM 2001'S SECOND QUARTER		PERCENTAGE CHANGE FROM 2001'S SECOND QUARTER		MILLIONS OF DOLLARS		MILLIONS OF DOLLARS	
ELECTRICAL PRODUCTS	262%	TELECOM EQUIP. & SERVICES	LOSS	GENERAL ELECTRIC	\$4,426	AT&T	-\$1,000
DRUG DISTRIBUTION	212	ELECTRONICS	LOSS	CITIGROUP	4,084	LUCENT TECHNOLOGIES**	-7
CHEMICALS	166	AIRLINES	LOSS	PHILIP MORRIS	2,610	MOTOROLA	-2
TEXTILES	159	SEMICONDUCTORS	LOSS	BANK OF AMERICA	2,221	KMART*	-1
MISCELLANEOUS LEISURE	156	INSTRUMENTS	LOSS	PFIZER	1,957	TELEPHONE & DATA SYSTEMS	-1
AUTO PARTS & EQUIPMENT	130	BUILDING MATERIALS	-81	SBC COMMUNICATIONS	1,845	AMR	-1
TIRE & RUBBER	123	PETROLEUM SERVICES	-75	AIG	1,801	AT&MEL	-1
BANKS - MIDWEST	121	COAL, OIL & GAS	-67	MERCK	1,751	CORNING	-1
GLASS CONTAINERS	105	COMPUTERS & PERIPHERALS	-36	JOHNSON & JOHNSON	1,654	HALLIBURTON	-1
FOREST PRODUCTS	99	ELECTRIC UTILITIES	-28	WAL-MART STORES*	1,652	PPG INDUSTRIES	-1
PUBLISHING	72	TELEPHONE COMPANIES	-27	MICROSOFT***	1,525	UAL	-1
FOOD PROCESSING	72	BUSINESS MACHINES & SVCS.	-21	FANNIE MAE	1,464	AGERE SYSTEMS**	-1
MISCELLANEOUS SERVICES	68	NONFERROUS METALS	-18	WELLS FARGO	1,420	SOLECTRON**	-1
GENERAL MANUFACTURING	67	HOTEL & MOTEL	-14	GENERAL MOTORS	1,292	US AIRWAYS GROUP	-1
HEALTH-CARE SERVICES	65	SPECIAL MACHINERY	-11	COCA-COLA	1,290	AGILENT TECHNOLOGIES	-1

ALL-INDUSTRY AVERAGE 9%

* Fiscal First Quarter

** Fiscal Third Quarter

*** Fiscal Fourth Quarter

Data: Standard & Poor's COMPUSTAT



hile, a weaker dollar is just start-
give a boost to manufacturers
goods overseas (page 82). That,
with the growth in productivity
loss domestic product, should bode
or sales in the second half, says
D. Rippe, chief economist at
ntial Securities Inc. "Even if they
push through minimal price in-
s, companies should start to see
revenue growth," he says.

t optimism is by no means uni-
however. In one earnings call af-
ther, CEOs have tripped over
elves talking about disappointing
spending, soft demand, under-
mining investments, and, of course,
undals besetting Corporate Amer-

managers are simply more cautious
And once new rules kick in reg-
g CEOs to sign off on financial
ments, they will likely be more
vative in reporting results as well.

les L. Hill, director of research at
on Financial/First Call, now be-
4% profit growth is the best that
00 companies can do for the year,
g to downgrades in earnings esti-
over recent months and a steep
profit decline in the first quarter.

ically, their profits have risen about
nually. What will help determine if
growth approaches even the lower
? Says Hill: "The big issue is
er consumers will hang in there."

Consumers have continued to gobble
ods despite the dour state of the
market. At Wal-Mart Stores Inc.,
stance, quarterly earnings rose an
ssive 20%, year to year, to \$1.65

. The auto makers also rebounded,
s to strong consumer spending and
own deep discounting. Even Ford
Co., after a disastrous 2001, post-
cond-quarter profits of \$570 mil-
s, a loss of \$752 million. And Gen-
Motors Corp.'s earnings soared
to \$1.29 billion. Chairman John F.

Smith Jr. vows to build on those results:
"We are determined to maintain our mo-
mentum in the second half of the year."
That, despite investor worries about the
future impact of GM's pension costs.

Another industrial heavyweight, Gen-
eral Electric Co., regained its place as
the biggest generator of profits. Its quar-
terly earnings rose 14%, to \$4.4 billion.
Company execs pointed to the growing
strength of GE's economy-sensitive units
like plastics as a sign that the economy is
truly rebounding. "I can only talk about
the world of GE, but I don't see anything
that indicates a double-dip activity," says
Chief Executive Jeffrey R. Immelt.

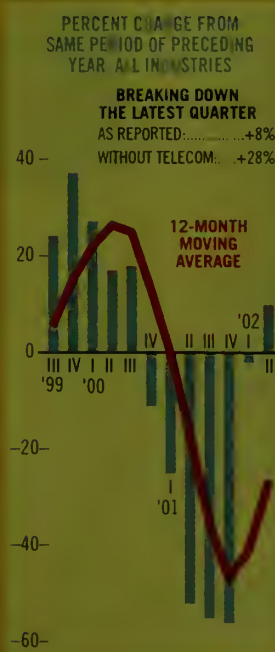
Nevertheless, some sectors still re-

main deeply profit-challenged. It's hard to
believe, but after two years of trouble,
telecom's problems are actually getting
worse. AT&T reported a \$12.7 billion loss
because of a \$13.1 billion charge to reflect
the decline of its cable operations. Lucent
Technologies Inc. lost \$7.8 billion, and
analyst Tal Liani of Merrill Lynch & Co.
doesn't see Lucent making money until
some time in 2004. And SBC Communi-
cations Inc.'s quarterly earnings fell 11%
to \$1.8 billion, thanks to competition from
wireless carriers and weaker demand.
Says a glum CEO Edward E. Whitacre
Jr.: "We do not anticipate a rebound in
demand for the rest of the year."

That could also be the refrain of the

A Spotlight on the Second Quarter

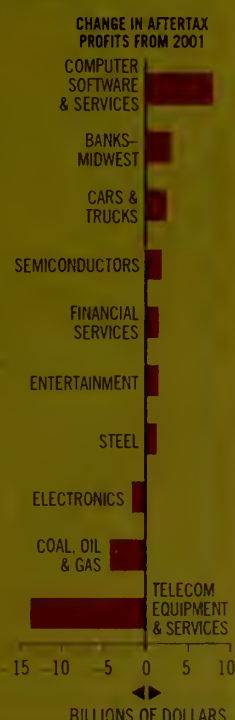
AFTERTAX PROFITS QUARTER BY QUARTER



Data: Standard & Poor's COMPUSTAT

INDUSTRIES WITH THE BIGGEST DOLLAR CHANGE IN THE QUARTER

Finally! After six quarters of
declines, profits actually rose
8% in the second quarter. And
while the 1% revenue gain isn't
exactly Herculean, it sure beats
the recent sales declines. Of
course, the profit comparison
is against a very weak year-ago
period, when earnings were off
52%. The auto makers were big
winners, with Ford coming back
from a loss and GM's profits
surging ahead 171%. In the
tech sector Microsoft reported
a healthy \$1.5 billion profit.
But the telecom companies
continued their dismal perform-
ance. Lucent and AT&T lost a
combined \$20.6 billion. And
profits at the oil companies fell
67%. ChevronTexaco earnings
plunged 81% to \$407 million.



Corporate Scoreboard

tech sector, which was marked by a 79% profit plunge at blue-chip IBM, to \$445 million, because of soft demand and more conservative accounting. There was one bright spot: Microsoft Corp. saw profits grow to \$1.53 billion from \$65 million. The software giant is now projecting revenue growth in each of its seven major product categories and plans to significantly boost research and development in fiscal 2003, which started July 1. Chief Financial Officer John Connors almost gloats over the poor showing of rivals such as IBM, Sun Microsystems, and Oracle. Says Connors: "People still ask, 'Are you a growth stock?' Compared to these guys in the last 12 months, yes, we are."



In the pharmaceutical sector, double-digit profit increases were once taken for granted. Not any more. Former highflier Merck & Co. saw earnings slump 4%, to \$1.8 billion, while Bristol-Myers Squibb's profits fell 60%, to \$440 million. Bristol blamed an onslaught of

generic drugs and bloated whole inventories for the plunge.

Scoreboard profits also took from weakness at Big Oil. Chevron Corp.'s earnings fell 81% on weak natural gas prices, tight refining margins and a \$531 million write-down of investment in troubled Dynegy Inc.

In the face of difficulties ranging from lower capital spending to the unexpected impact of business scandals, and compounded by Thomson Financial/Fitly, have sharply lowered third quarter growth forecasts for S&P 500 companies to 12.8% from 20.7% back in June. Things will get better. It's just not going to happen overnight.

By Diane Brady in New York, bureau reports

THE DECLINING DOLLAR: A BALM FOR BATTERED PROFITS

For the past five years, the strong dollar has hurt many U.S. companies as earnings repatriated in weaker currencies served to put a crimp in profits, not to mention sales. The boom years of the late 1990s masked that to some degree. But the subsequent weak economy made the impact of the muscular American currency increasingly apparent. After all, about 25% of U.S. corporate profits come from overseas.

Happily for investors and corporate executives, the greenback has fallen steadily against major currencies since the beginning of the year. In that time, the dollar has lost 10% of its value against the euro and 9% against the yen. If that decline continues, it should mean better times ahead for bottom lines. Of course, companies that make goods overseas for sale here—such as electrical or computer components—could be hurt by a declining dollar. Those parts become more expensive. But overall, the National Association of Manufacturers (NAM) figures that corporate profits will rise 7.1% next year if the dollar falls by 15% from now to mid-2003. Without a lower dollar, profits will be up just 4.7%. The falling dollar is "a balm on the earnings of U.S. corporations," says Mark M. Zandi, chief economist at Economy.com Inc.

The turnaround will make a big difference for companies such as St. Jude Medical Inc., a \$1.35 billion manufacturer of pacemakers that

does about a quarter of its business in Western Europe. Since 1997, the St. Paul (Minn.) company reckons that because of currency adjustments, its profits were about 0.33% lower, while the negative impact on sales totaled a full percentage point. In 2001, that translated to \$500,000 less in profits and \$16 million less in revenues. But the company expects its fortunes to brighten if the dollar keeps falling.

Currency fluctuations take a few months to show an impact, so the dollar's drop didn't help St. Jude in the second quarter. But if the dollar stays at current levels, currency translations should boost profits as well as add \$14 million in sales in the second half, says Chief Financial Officer John C. Heinmiller. That translates into revenue growth of 16%, beating the company's current goal of 15%. "It has been several years since we've had this kind of tailwind," Heinmiller says. "One percentage point is certainly significant. It does have a positive impact."

U.S. companies that depend heavily on exports should benefit from the declining dollar as domestic goods become more competitive in international markets. In recent weeks,

companies such as aerospace giant General Dynamics, battery maker Energizer Holdings, and auto-parts supplier Delphi have already noted the benefits of the declining dollar explaining their numbers to investors. In June, the NAM released survey of executives showing that 82% expect the lower dollar to boost exports in the last quarter of 2002.

A drop in the dollar doesn't come

without risks. In addition to hurting exporters, a precipitous decline could induce companies to raise prices in response to higher-priced imported goods, as many did in the late 1980s. But economists say that's not likely. "There's not much of an inflation threat right now," says L. Douglas Lee, presi-

dent of Economics From Washington Inc., an economic consulting firm. "Competition is strong, and the global economy is quite weak."

So investors should generally view the dollar's latest drop as a good thing. As long as the decline is gradual, the greenback should continue to give U.S. corporations a nice boost. And it should happen just as both Big Business and investors are sorely in need of some positive news.

By Laura Cohn in Washington, with Michael Arndt in Chicago

THE BUCK DROPS HERE



Second Quarter 2002

CORPORATE SCOREBOARD

Sales

Includes all sales and operating revenues. For companies that do not include all operating revenues.

Net Income: Net income before extraordinary items. For banks,

profits are net income after security gains or losses.

MARGINS: Net income from continuing operations before extraordinary items as percent of sales.

RETURN ON COMMON EQUITY: Ratio of net income available

for common stockholders (most recent 12 months) to latest available common equity, which includes common stock, capital surplus, and retained earnings.

PRICE-EARNINGS RATIO: Based on July 25, 2002, common-

stock price and corporate earnings from continuing operations before extraordinary items for most recent 12-month period.

EARNINGS PER SHARE: For most recent 12-month period. Includes all common-stock equivalents.

COMPANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE- EARNINGS RATIO 7-25	12 MONTHS' EARNINGS PER SHARE
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %			
INDUSTRY COMPOSITE	1597718.4	1	3140195.7	-1	70175.1	8	155052.5	13	4.4	4.1	8.4	32	0.84
AEROSPACE & DEFENSE													
INDUSTRY COMPOSITE	41175.8	0	80135.8	5	2539.1	15	4437.4	-3	6.2	5.4	11.8	23	2.24
AEROSPACE BEAV ⁽¹⁰⁾	154.3	-13	306.1	-11	-1.5	NM	-6.8	NM	NM	4.4	-82.7	NM	-3.00
BA	13857.0	-11	27678.0	-4	779.0	-7	1357.0	-35	5.6	5.4	20.3	17	2.60
AL DYNAMICS GD	3511.0	19	6632.0	18	263.0	16	492.0	5	7.5	7.7	20.4	18	4.77
CH GR	925.5	-14	1846.7	-11	58.6	-23	108.2	-26	6.3	7.1	10.1	17	1.29
DEED MARTIN LMT	6290.0	11	12256.0	17	351.0	134	575.0	108	5.6	2.6	5.2	74	0.82
ROP GRUMMAN NOC	4396.0	20	8482.0	50	182.0	60	331.0	53	4.1	3.1	6.4	22	4.92
EON RTN	4095.0	0	8006.0	2	223.0	64	372.0	62	5.4	3.3	1.5	93	0.33
VELL COLLINS COL ⁽³⁾	623.0	-14	1231.0	-13	60.0	-12	118.0	-9	9.6	9.4	9.7	38	0.64
D TECHNOLOGIES UTX	7324.0**	0	13698.0	-2	624.0	6	1091.0	6	8.5	8.0	21.5	17	3.96
AUTOMOTIVE													
INDUSTRY COMPOSITE	128136.0	3	248279.1	1	2783.1	NM	2747.9	170	2.2	0.1	-7.4	NM	-0.86
CARS & TRUCKS													
INDUSTRY COMPOSITE	94072.8	2	183190.3	2	1931.7	NM	2058.9	92	2.1	NM	-11.9	NM	-1.34
MOTOR F	42332.0	0	82189.0	-3	570.0	NM	478.0	56	1.3	NM	-71.4	NM	-2.94
AL MOTORS GM	48265.0**	4	94558.0	6	1292.0	171	1520.0	113	2.7	1.0	6.7	14	3.21
TAR INTERNATIONAL NAV ⁽²⁾	1674.0	-6	3140.0	-5	-4.0	NM	-60.0	NM	NM	0.2	-4.7	NM	-0.86
R PCAR	1801.8	18	3303.3	8	73.7	87	120.9	44	4.1	2.6	9.2	20	1.82
ARTS & EQUIPMENT													
INDUSTRY COMPOSITE	29517.2	4	56226.1	1	771.9	130	645.4	NM	2.6	1.2	-0.8	NM	-0.11
ST INDUSTRIAL AIZ ⁽⁴⁾	151.4	11	288.4	11	-1.6	NM	-6.5	NM	NM	NM	-22.4	NM	-2.70
CAN AXLE & MFG. HOLDINGS AXL	881.3	9	1740.5	11	48.6	43	87.4	51	5.5	4.2	22.5	8	2.80
MERITOR ARM ⁽³⁾	1883.0	5	3570.0	0	62.0	77	97.0	73	3.3	2.0	12.9	13	1.52
IV ALV	1169.1	13	2198.1	4	52.5	75	91.5	80	4.5	2.9	4.5	24	0.90
WARNER BWA	712.4	18	1346.3	11	45.7	85	77.2	69	6.4	4.1	10.4	15	3.66
OCN	2866.0**	2	5440.0	-2	52.0	271	43.0	NM	1.8	0.5	-13.8	NM	-1.64
II DPH	7322.0	5	14010.0	4	220.0	34	169.0	NM	3.0	2.4	2.6	85	0.12
AUTOMOTIVE SYSTEMS DRRA	667.3	0	1283.5	-3	-4.6	NM	6.7	-70	NM	1.9	-0.9	NM	-0.25
ETN	1881.0	1	3604.0	-6	88.0	80	121.0	22	4.7	2.6	7.4	25	2.67
ORP GY ⁽¹⁾	303.0	-26	552.0	-28	6.0	20	9.0	-53	2.0	1.2	35.9	4	2.75
LEMMEZ INTERNATIONAL HLMMQ ⁽¹¹⁾	486.7	-10	951.4	-6	-33.0	NM	-243.0	NM	NM	NM	NM	NM	-12.95
LEA	3792.2	5	7326.8	3	85.5	90	131.9	122	2.3	1.2	7.3	26	1.58
ME MFG. MODI ⁽⁹⁾	272.6	2	527.2	-4	10.4	2	15.4	0	3.8	3.7	4.4	32	0.70
CARD MOTOR PRODUCTS SMP	179.3	-1	305.4	-9	5.5	140	3.2	11	3.0	1.3	0.4	NM	0.05
RIOR INDUSTRIES INTERNATIONAL SUP	212.0	31	398.5	21	21.0	57	38.1	30	9.9	8.2	12.8	18	2.42
ECO AUTOMOTIVE TEN	948.0	2	1757.0	-2	19.0	850	17.0	NM	2.0	0.2	-76.4	NM	-2.18
R AUTOMOTIVE TWR	750.9	17	1419.0	12	22.9	37	-11.6	NM	3.0	2.6	-54.5	NM	-6.40
ON VC	5039.0	3	9508.0	-1	72.0	NM	-1.0	NM	1.4	NM	-3.5	NM	-0.86

1 First quarter ended May 31. (2) Second quarter ended Apr. 30. (3) Third quarter and most recent six months ended June 30. (4) Third quarter and most recent six months ended May 31. (5) Third quarter and most recent six months ended Apr. 30. (6) Fourth quarter and most recent six months ended June 30. (7) Fourth quarter and most recent six months ended May 31. (8) Fourth quarter and most recent six months ended Apr. 30. (9) First quarter and most recent six months ended June 30. (10) First quarter and most recent six months ended May 31. (11) First quarter and most recent six months ended Apr. 30. *Sales include taxes. **Sales include other income. ***Sales include excise taxes and other income. †Revenues from major subsidiaries not included in consolidated sales. Earnings per share are for latest 12 months, not necessarily end of most recent fiscal year. they include all common-stock equivalents but exclude extraordinary items. NA = not available. NM = not meaningful.

Data: Standard & Poor's COMPUSTAT

CORPORATE SCOREBOARD

COMPANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE-EARNINGS RATIO 7-25
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %		
(C) TIRE & RUBBER												
GROUP COMPOSITE	4546.0	-2	8862.7	-2	79.5	123	43.7	NM	1.7	0.8	-2.2	NM
BANDAG BDG	231.1	-4	423.6	-5	11.7	23	12.9	9	5.0	4.0	11.1	13
COOPER TIRE & RUBBER CTB	836.1	1	1649.1	4	39.0	113	65.1	196	4.7	2.2	6.3	24
GOODYEAR TIRE & RUBBER GT	3478.8	-3	6790.0	-3	28.9	271	-34.3	NM	0.8	0.2	-7.0	NM
3 BANKS												
INDUSTRY COMPOSITE	78155.1	-7	155578.3	-10	12569.8	40	25735.5	31	16.1	10.7	13.2	15
(A) BANKS - EAST												
GROUP COMPOSITE	23745.5	-10	47534.3	-14	2526.7	8	5844.6	15	10.6	8.8	9.9	18
ASSOCIATED BANC-CORP ASBC	251.8	-9	493.5	-11	52.2	13	103.5	17	20.7	16.6	15.3	13
BANCORPSOUTH BXS	181.6	-10	366.1	-9	30.9	33	60.3	32	17.0	11.5	13.6	13
BANK OF NEW YORK BK	1523.0	-14	2996.0	-18	361.0	-6	723.0	-6	23.7	21.6	19.6	17
BANKNORTH GROUP BKNG	372.4	0	740.0	-3	75.0	25	142.3	23	20.1	16.0	14.9	13
COLONIAL BANCGROUP CNB	218.5	-14	431.3	-16	36.1	18	70.2	18	16.5	12.0	14.0	11
COMMERCE BANCORP CBH	250.1**	29	474.2	24	34.8	39	66.6	37	13.9	12.9	15.7	23
FLEETBOSTON FINANCIAL FBF	3677.0	-21	7775.0	-13	-106.0	NM	630.0	-7	NM	11.2	5.2	24
J.P. MORGAN CHASE JPM	11190.0	-11	22147.0	-20	1028.0	172	2010.0	27	9.2	3.0	5.0	22
M&T BANK MTB	582.6	-11	1168.0	-11	121.5	28	242.1	36	20.9	14.4	14.8	17
MBNA KRB	2529.2	4	5041.2	7	457.8	20	827.8	20	18.1	15.6	23.3	12
MELLON FINANCIAL MEL	1198.0	20	2410.0	12	106.0	4	317.0	5	8.8	10.2	13.8	24
MERCANTILE BANKSHARES MRBK	183.4	-9	364.7	-10	46.9	5	93.1	2	25.6	22.1	14.3	14
NORTH FORK BANCORPORATION NFB	322.9	9	637.4	6	104.5	34	202.8	29	32.4	26.4	23.5	16
STATE STREET STT	1265.0	-14	2490.0	-16	178.0	7	356.0	24	14.1	11.4	16.6	18
(B) BANKS - MIDWEST												
GROUP COMPOSITE	25681.6	-1	51005.3	-6	4882.7	121	9693.4	64	19.0	8.6	15.7	15
BANK ONE ONE	5621.0	-9	11113.0	-13	843.0	19	1630.0	18	15.0	11.5	13.5	14
CHARTER ONE FINANCIAL CF	721.0	4	1402.3	1	143.3	19	283.1	20	19.9	17.3	18.1	13
COMERICA CMA	927.0	-15	1847.0	-16	184.0	-12	398.0	32	19.8	19.1	16.3	12
COMMERCE BANKSHARES CBSH	232.7**	-12	465.6	-12	50.1	9	97.0	8	21.5	17.4	13.8	14
FIFTH THIRD BANCORP FITB	1554.2	-6	3068.2	-8	404.3	214	794.4	83	26.0	7.8	18.7	25
FIRSTMERIT FMER	207.1	-10	419.4	-10	42.0	6	85.5	8	20.3	17.3	14.0	15
KEYCORP KEY	1550.0	-17	3085.0	-21	246.0	NM	486.0	493	15.9	NM	8.5	18
MARSHALL & ILSLEY MI	654.3	-4	1293.7	-7	120.4	102	236.1	61	18.4	8.7	15.5	14
NATIONAL CITY NCC	2209.2	-5	4457.3	-5	392.8	12	838.9	22	17.8	15.0	19.4	11
NORTHERN TRUST NTRS	711.5	-18	1418.2	-19	126.8	-3	254.4	-2	17.8	15.2	17.2	16
SKY FINANCIAL GROUP SKYF	189.6	-1	374.0	-3	28.9	-1	60.4	4	15.2	15.3	18.3	13
TCF FINANCIAL TCB	286.0	-7	573.3	-5	58.0	11	114.3	14	20.3	16.9	24.1	15
U.S. BANCORP USB	3812.9	-8	7502.4	-12	823.1	46	1616.3	66	21.6	13.5	14.1	15
WELLS FARGO WFC	7005.0	31	13986.0	11	1420.0	NM	2799.0	160	20.3	NM	17.4	16
(C) BANKS - SOUTH & SOUTHEAST												
GROUP COMPOSITE	27000.5	-9	53643.3	-10	4837.6	16	9572.6	19	17.9	14.1	13.4	14
AMSOUTH BANCORPORATION ASO	760.1	-12	1514.9	-13	152.4	14	297.9	15	20.0	15.4	19.2	13
BANK OF AMERICA BAC	11465.0	-16	22776.0	-18	2221.0	10	4400.0	13	19.4	14.8	15.3	13
BB&T BBT	1526.3	-3	2982.7	-6	328.0	38	627.8	33	21.5	15.1	16.0	14
FIRST CITIZENS BANKSHARES FCNCA	207.0	-13	417.4	-13	23.1	5	46.3	3	11.2	9.3	9.5	12
FIRST TENNESSEE NATIONAL FTN	585.3	-10	1168.2	-5	90.5	2	177.5	17	15.5	13.7	23.4	13
FIRST VIRGINIA BANKS FVB	194.8	1	387.5	-1	46.6	25	88.8	14	23.9	19.3	14.4	14
HIBERNIA HIB	331.5	-13	662.5	-14	62.5	14	121.8	16	18.9	14.4	14.5	13
NATIONAL COMMERCE FINANCIAL NCF	379.7	-2	747.7	-5	80.9	46	155.8	44	21.3	14.3	10.8	18
POPULAR BPOP	641.0	-1	1267.2	-3	96.3	24	185.3	23	15.0	12.0	15.2	13
REGIONS FINANCIAL RF	929.4	-13	1849.6	-9	153.1	36	307.2	30	16.5	10.5	14.7	13
SOUTHTRUST SOTR	831.7	-13	1667.4	-13	158.2	15	312.4	17	19.0	14.5	13.9	14
SUNTRUST BANKS STI	1917.8	-11	3830.6	-13	343.7	-6	648.6	-8	17.9	16.9	14.6	13
SYNOVUS FINANCIAL SNV	566.5	-2	1113.8	-4	85.9	14	168.6	14	15.2	13.1	18.3	19
UNION PLANTERS UPC	660.4	-18	1323.7	-18	127.6	17	253.5	18	19.3	13.6	14.9	12
WACHOVIA WB	6004.0	10	11934.0	8	868.0	37	1781.0	46	14.5	11.6	7.5	21
(D) BANKS - WEST & SOUTHWEST												
GROUP COMPOSITE	1727.4	-11	3395.4	-16	322.8	14	625.0	12	18.7	14.6	13.2	14
BANK OF HAWAII BOH	180.9	-38	373.2	-40	31.0	16	62.1	3	17.1	9.2	10.0	16
BOK FINANCIAL BOKF	227.6	0	424.3	-10	34.1	18	66.5	18	15.0	12.7	14.6	14
CITY NATIONAL CYN	194.2	3	378.6	-2	45.8	26	90.0	29	23.6	19.2	15.5	15
UNIONBANCAL UB	652.0	-11	1285.8	-15	129.9	11	244.7	9	19.9	16.0	13.3	13
ZIONS BANCORPORATION ZION	472.7	-6	933.5	-9	82.1	12	161.7	11	17.4	14.7	13.1	14
4 CHEMICALS												
INDUSTRY COMPOSITE	22818.1	-4	43140.3	-7	1452.3	166	2472.8	230	6.4	2.3	16.5	15
AIR PRODUCTS & CHEMICALS APD (3)	1374.0	-5	2686.7	-10	141.3	7	267.4	18	10.3	9.1	16.1	19
ALBEMARLE ALB	245.1	16	469.7	8	20.7	40	37.5	0	8.4	7.0	12.6	19
CROMPTON CK	689.7	-5	1334.6	-9	-6.3	NM	0.5	-98	NM	1.9	-54.9	NM

INDUSTRY SCOREBOARD

ANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE-EARNINGS RATIO 7-25	12 MONTHS' EARNINGS PER SHARE
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %			
INDUSTRIES CYT	350.9	-1	668.9	-8	21.4	2	28.4	-25	6.1	5.9	8.4	19	1.38
CHEMICAL COO	7217.0**	-2	13479.0	-8	238.0	-15	276.0	NM	3.3	3.8	2.9	92	0.32
T OO	6700.0**	-4	12842.0	-7	543.0	NM	1022.0	277	8.1	NM	36.3	8	4.96
C	482.4	-8	916.6	-6	19.2	NM	28.2	NM	4.0	NM	2.8	NM	0.14
(H.B.) FULL ⁽¹⁾	319.4	-3	612.6	-4	7.9	-33	8.6	-51	2.5	3.6	8.2	22	1.28
(W.R.) GRA	473.4	5	886.9	5	21.2	-8	33.6	-11	4.5	5.1	NM	2	1.13
LAKES CHEMICAL GLK	408.5	1	713.5	-5	22.1	NM	27.2	NM	5.4	NM	-17.6	NM	-2.56
NATIONAL FLAVORS & FRAGRANCES IFF	475.3	0	922.2	-4	45.4	38	87.3	64	9.5	6.9	25.8	19	1.56
OL LZ	508.4	4	975.9	4	34.5	8	64.3	27	6.8	6.6	12.7	14	2.08
ALS TECHNOLOGIES MTX	186.8	9	365.8	9	14.0	35	27.5	25	7.5	6.1	9.6	14	2.72
NTO MON	1580.0	-21	2801.0	-16	147.0	-62	233.0	-47	9.3	19.3	1.5	45	0.31
R PX	1307.0	-1	2539.0	-4	150.0	19	277.0	10	11.5	9.6	17.8	19	2.77
MAN (A.) SHLM ⁽⁴⁾	259.6	3	473.2	-4	11.7	80	16.2	104	4.5	2.6	7.9	21	0.91
NT TECHNOLOGIES SXT	239.6	17	452.7	13	21.2	16	38.1	30	8.8	9.0	15.6	13	1.55
CONGLOMERATES													
TRY COMPOSITE	58520.1	1	112417.3	-1	5191.3	-2	6961.3	611	8.9	9.2	16.4	19	1.24
R INTERNATIONAL AXE	617.3	-26	1232.0	-28	12.8	-32	22.3	-44	2.1	2.2	2.7	50	0.41
AL ELECTRIC GE	33128.0**	4	63594.0	2	4426.0	14	7944.0	15	13.4	12.2	27.5	18	1.51
WELL INTERNATIONAL HON	5651.0	-7	10850.0	-10	459.0	818	835.0	818	8.1	0.8	6.8	39	0.78
FFICE SOLUTIONS IKN ⁽³⁾	1218.6	-7	2438.8	-9	43.1	66	78.4	84	3.5	2.0	4.4	19	0.42
L ⁽⁵⁾	302.4	-6	587.8	-6	26.4	-28	44.9	-33	8.7	11.5	11.5	23	0.72
ERICAS PAS	884.7	3	1621.6	4	54.8	55	78.2	62	6.2	4.1	8.0	18	0.78
ON TXT	2824.0**	-14	5242.0	-17	105.0	-17	162.0	-32	3.7	3.8	2.2	62	0.61
RW	4269.0	7	8119.0	3	124.0	NM	202.0	910	2.9	NM	11.2	31	1.66
INTERNATIONAL TYC ⁽³⁾	9123.7	5	17785.2	2	-84.1	NM	-2443.2	NM	NM	12.8	1.4	39	0.21
R INDUSTRIES WLT	501.4	-3	946.9	-3	24.2	69	37.7	91	4.8	2.8	17.2	9	1.36
CONSUMER PRODUCTS													
TRY COMPOSITE	77246.6	7	152046.9	7	8437.1	18	15562.7	20	10.9	9.9	30.0	19	2.06
PARCEL													
P COMPOSITE	7902.5	0	15360.7	-1	441.9	17	747.1	6	5.6	4.8	14.1	19	1.73
I SHOE BWS ⁽¹¹⁾	446.7	2	862.0	2	7.6	19	-15.5	NM	1.7	1.5	0.8	NM	0.10
OD KWD ⁽¹¹⁾	570.7	-20	1040.7	-17	8.5	-66	5.4	-77	1.5	3.5	4.6	29	0.92
IBORNE LIZ	789.5	9	1682.4	8	38.8	20	89.7	15	4.9	4.5	18.1	14	1.92
KE ⁽⁷⁾	2682.2	8	4942.5	6	208.4	28	334.7	29	7.8	6.6	17.4	20	2.46
O INDUSTRIES OXM ⁽⁷⁾	191.7	-11	341.2	-17	5.6	7	7.0	-24	2.9	2.4	6.0	15	1.40
PS-VAN HEUSEN PVH ⁽¹¹⁾	349.4	-5	675.0	-9	-0.8	NM	-10.3	NM	NM	0.2	3.5	36	0.33
LVER ZQK ⁽²⁾	187.4	11	334.4	14	13.5	-4	16.5	-6	7.2	8.2	11.3	19	1.11
K INTERNATIONAL RBK	717.4	1	1453.4	-2	24.6	74	61.6	11	3.4	2.0	13.8	15	1.72
ERS U.S.A. SKX	256.7	11	501.6	9	21.3	26	41.5	22	8.3	7.3	21.8	11	1.40
RITE SRR ⁽¹⁾	156.5	2	297.2	-2	11.6	15	19.1	7	7.4	6.5	7.3	15	0.48
RLAND TBL	191.5	-5	417.2	-7	4.9	-53	13.9	-50	2.6	5.2	27.0	15	2.35
	1193.5**	-10	2466.5	-10	88.9	28	167.9	14	7.4	5.2	9.1	27	1.34
RINE WORLD WIDE WWW	169.3	12	346.6	12	9.1	3	15.5	4	5.4	5.8	12.1	13	1.08
PLIANCES & HOME FURNISHINGS													
P COMPOSITE	15953.9	14	35780.1	15	467.3	49	1442.2	52	2.9	2.2	15.1	22	1.13
ATH & BEYOND BBY ⁽¹⁰⁾	776.8	35	1655.9	25	46.3	54	129.0	37	6.0	5.2	20.5	38	0.79
JUY BBY ⁽¹⁰⁾	4586.0	24	11566.0	26	70.0	27	420.0	71	1.5	1.5	21.9	17	1.81
T CITY GROUP CC ⁽¹⁰⁾	2118.2	13	5509.9	9	17.5	72	170.2	53	0.8	0.5	7.7	16	0.94
RS FJC ⁽⁴⁾	170.7	-10	243.8	-11	12.9	88	11.0	65	7.6	3.6	-29.0	NM	-0.58
GUYS GGUY ⁽¹⁰⁾	171.0	0	430.2	NA	-4.6	NM	-21.9	NA	NM	NM	-62.8	NM	-1.49
TY FURNITURE HVT	167.0	8	344.4	6	3.7	46	10.5	52	2.2	1.7	12.4	10	1.20
OY LZB ⁽⁸⁾	596.1	1	1139.6	0	24.9	141	46.5	76	4.2	1.7	8.7	21	1.01
TT & PLATT LEG	1115.3	8	2138.0	2	70.3	38	126.5	31	6.3	4.9	11.2	20	1.09
S 'N THINGS LIN	461.9	19	918.8	20	5.6	165	10.7	58	1.2	0.5	5.5	31	0.81
IG MYG	1193.0	22	2370.6	21	68.3	147	126.4	97	5.7	2.8	119.1	11	2.93
IMPORTS PIR ⁽¹⁰⁾	384.4**	18	863.0	14	22.2	80	71.2	46	5.8	3.8	18.2	14	1.14
SHACK RSH	998.1	-4	2032.5	-7	51.8	26	109.4	25	5.2	4.0	25.5	25	1.00
POOL WHR	2737.0	6	5311.0	4	63.0	-15	148.0	38	2.3	2.9	8.4	53	1.03
AMS-SONOMA WSM ⁽¹¹⁾	478.4	15	1256.4	15	15.4	NM	84.8	88	3.2	0.1	16.3	29	0.77
BEVERAGES													
P COMPOSITE	24303.2	10	44233.8	9	3285.5	18	5375.0	16	13.5	12.6	29.5	26	1.60
USER-BUSCH BUO	3626.1	5	6762.7	4	586.5	12	1042.6	14	16.2	15.2	45.0	23	2.05
N-FORMAN BF.B ⁽⁸⁾	460.1**	4	964.0	3	51.2	-5	108.5	-2	11.1	12.2	18.1	19	3.33
COLA KO	5368.0	15	9447.0	10	1290.0	15	2091.0	5	24.0	24.0	35.9	29	1.64
COLA BOTTLING CONSOLIDATED COKE	341.1	30	624.3	28	10.8	115	14.2	339	3.2	1.9	68.9	21	2.30
COLA ENTERPRISES CCE	4448.0	9	8090.0	9	215.0	105	226.0	NM	4.8	2.6	7.1	42	0.43

CORPORATE SCOREBOARD

COMPANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE-EARNINGS RATIO 7-25
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %		
CONSTELLATION BRANOS STZ ⁽¹⁰⁾	648.9	9	1322.5	16	37.4	57	65.9	56	5.8	4.0	15.0	16
COORS (AOLPH) RKY	1024.0	48	1763.3	43	67.6	36	94.8	39	6.6	7.2	15.3	14
PEPSI BOTTLING GROUP PBG	2209.0	7	3981.0	7	139.0	20	193.0	36	6.3	5.6	18.9	21
PEPSICO PEP	6178.0	5	11279.0	7	888.0	11	1539.0	13	14.4	13.6	28.2	26
(D) PERSONAL CARE												
GROUP COMPOSITE	10429.6	7	20164.8	5	1284.6	13	2404.7	11	12.3	11.6	48.7	25
AVON PRODUCTS AVP	1527.2	4	2910.8	3	154.9	12	251.1	14	10.1	9.4	NM	24
COLGATE-PALMOLIVE CL	2297.0	3	4492.2	1	327.0	14	616.7	11	14.2	12.8	385.1	25
OIAL DL	333.3	6	640.7	5	33.4	110	57.0	86	10.0	5.0	132.6	19
ECOLAB ECL	839.2	43	1625.3	40	51.7	7	88.7	-4	6.2	8.2	19.0	31
GILLETTE G	2024.0	5	3756.0	6	293.0	26	516.0	25	14.5	12.1	42.6	33
KIMBERLY-CLARK KMB	3408.9	5	6739.8	3	424.6	2	875.2	3	12.5	12.8	28.5	19
(E) TOBACCO												
GROUP COMPOSITE	18657.3	1	36507.5	2	2957.8	17	5593.6	23	15.9	13.7	36.8	10
PHILIP MORRIS MO	16520.0	1	32480.0	2	2610.0	14	4975.0	22	15.8	13.9	46.1	10
R.J. REYNOLDS TOBACCO HOLDINGS RJR	1705.0	0	3220.0	2	211.0	66	378.0	67	12.4	7.5	7.9	8
UST UST	432.3	6	807.5	3	136.8	12	240.6	5	31.7	29.9	78.2	9
7 CONTAINERS & PACKAGING												
INDUSTRY COMPOSITE	14989.2	17	28275.0	13	420.9	28	287.6	-46	2.8	2.6	-0.4	NM
(A) GLASS, METAL & PLASTIC												
GROUP COMPOSITE	4320.5	1	8074.3	0	185.8	105	-79.3	NM	4.3	2.1	-42.6	NM
BALL BLL	1034.2	4	1910.1	4	49.9	NM	77.4	NM	4.8	NM	24.6	18
CROWN CORK & SEAL CCK	1789.0	-5	3356.0	-5	39.0	680	-15.0	NM	2.2	0.3	NM	NM
OWENS-ILLINOIS OI	1497.3	8	2808.2	4	96.9	-61	-141.7	NM	6.5	17.8	-10.3	NM
(B) PAPER												
GROUP COMPOSITE	10668.7	25	20200.7	19	235.1	-1	366.9	-14	2.2	2.8	4.9	29
BEMIS BMS	584.8	1	1137.5	-2	44.0	24	78.9	21	7.5	6.1	16.3	16
CHESAPEAKE CSK	189.0	1	371.1	-4	0.3	-88	0.0	NM	0.2	1.4	1.6	43
GRAPHIC PACKAGING INTERNATIONAL GPK	263.9	-7	527.6	-8	2.8	-24	7.8	5	1.1	1.3	-0.8	NM
GREIF BROS. GBCOA ⁽²⁾	396.9	11	762.1	32	6.9	-70	10.7	-83	1.7	6.4	6.4	15
LONGVIEW FIBRE LFB ⁽²⁾	183.3	-14	360.8	-17	0.0	NM	-6.0	NM	0.0	2.0	1.5	69
MAIL-WELL MWL	421.0	-11	864.4	-10	-28.8	NM	-37.7	NM	NM	NM	-20.6	NM
MEADOWS PACIFIC MWV	2012.0	NA	3473.0	NA	-8.0	NA	-71.0	NA	NM	NA	-0.7	NA
PACKAGING CORP. OF AMERICA PKG	447.4	-4	862.1	-6	11.6	-63	21.2	-64	2.6	6.7	8.9	27
PACTIV PTV	728.0	0	1375.0	-2	60.0	33	102.0	38	8.2	6.2	11.2	15
POTLATCH PCH	333.2	-1	651.4	1	-6.6	NM	-21.5	NM	NM	NM	-11.6	NM
ROCK-TENN RKT ⁽³⁾	357.7	0	705.8	-3	6.1	-33	17.7	8	1.7	2.6	9.2	11
SEALEO AIR SEE	786.3	3	1532.4	1	66.0	68	126.6	71	8.4	5.2	18.3	20
SMURFIT-STONE CONTAINER SSCC	2051.0	-3	3981.0	-7	27.0	59	36.0	0	1.3	0.8	3.0	47
SONOCO PRODUCTS SON	712.4	10	1366.6	7	37.7	123	71.3	230	5.3	2.6	16.3	16
TEMPLE-INLAND TIN	1202.0	13	2230.0	5	16.0	-45	31.0	-24	1.3	2.7	5.3	25
8 DISCOUNT & FASHION RETAILING												
INDUSTRY COMPOSITE	178965.0	9	390172.3	7	4033.4	20	9675.7	2	2.3	2.1	11.2	32
ABERCROMBIE & FITCH ANF ⁽¹¹⁾	312.8	19	779.4	11	23.3	13	102.5	5	7.4	7.8	27.7	13
ALBERTO-CULVER ACV ⁽³⁾	681.1	13	1338.8	12	36.4	25	69.1	26	5.3	4.8	15.8	21
AMAZON.COM AMZN	805.6	21	1653.0	21	-93.6	NM	-117.5	NM	NM	NM	NM	NM
AMERICAN EAGLE OUTFITTERS AEOS ⁽¹¹⁾	277.9	10	742.2	10	12.7	-18	56.6	-12	4.6	6.2	19.8	12
AMES DEPARTMENT STORES AMESQ ⁽¹¹⁾	567.9**	-28	1545.3	-27	-49.1	NM	-221.9	NM	NM	NM	NM	NM
ANN TAYLOR STORES ANN ⁽¹¹⁾	345.4**	12	716.8	10	20.9	91	20.6	40	6.1	3.6	6.0	27
AUTOZONE AZO ⁽⁴⁾	1224.8	7	2306.1	9	102.3	61	166.1	74	8.4	5.6	35.7	27
BARNES & NOBLE BKS ⁽¹¹⁾	1133.1	12	2948.3	13	-16.3	NM	67.6	NM	NM	NM	6.0	28
BIG LOTS BLI ⁽¹¹⁾	904.1	17	2042.4	8	12.2	NM	10.3	-85	1.4	0.0	-1.8	NM
BJ'S WHOLESALE CLUB BJ ⁽¹¹⁾	1291.8	11	2834.9	6	23.1	0	79.4	2	1.8	2.0	11.9	30
BON-TON STORES BONT ⁽¹¹⁾	151.1**	1	397.7	-5	-4.4	NM	10.4	-14	NM	NM	3.4	10
BORERS GROUP BGP ⁽¹¹⁾	751.7	3	1956.2	2	3.9	NM	113.2	99	0.5	NM	11.4	12
BUILDING MATERIALS HOLDING BMHC	300.5	12	547.7	11	7.3	3	7.9	-14	2.4	2.6	8.1	7
CATO CTR ⁽¹¹⁾	201.6**	9	391.3	4	18.3	15	29.5	20	9.1	8.6	18.1	12
COW COMPUTER CENTERS CDWC	1056.8	6	2059.7	4	44.1	2	84.8	2	4.2	4.3	19.9	25
CHARMING SHOPPES CHRS ⁽¹¹⁾	630.6	60	1277.7	54	16.3	95	-11.5	NM	2.6	2.1	0.6	NM
CHILDREN'S PLACE RETAIL STORES PACE ⁽¹¹⁾	173.0	8	371.8	8	15.2	19	34.1	23	8.8	8.0	21.0	13
CLAIRE'S STORES CLE ⁽¹¹⁾	210.4	-1	490.8	-3	8.3	-10	38.1	-4	3.9	4.3	9.7	21
COLE NATIONAL CNJ ⁽¹¹⁾	290.1	7	586.3	3	2.9	349	8.2	88	1.0	0.2	4.6	31
COSTCO WHOLESALE COST ⁽⁴⁾	8616.7**	12	17999.6	12	130.4	24	322.9	15	1.5	1.4	11.9	25

PORATE SCOREBOARD

PANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE- EARNINGS RATIO 7-25	12 MONTHS' EARNINGS PER SHARE
	2NO QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2NO QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2NO QUARTER 2002 %	2NO QUARTER 2001 %			
UTO CAO ⁽¹¹⁾	375.6	5	709.6	0	3.4	50	5.0	NM	0.9	0.6	-8.1	NM	-0.52
IO'S DDS ⁽¹¹⁾	1972.8**	0	4567.9	-3	57.8	124	158.5	87	2.9	1.3	3.6	20	1.16
R GENERAL DG ⁽¹¹⁾	1389.4	16	2975.4	13	45.9	27	143.4	NM	3.3	3.0	20.0	26	0.65
BARN DBRN ⁽⁵⁾	177.1	7	348.4	6	9.5	55	16.6	16	5.4	3.7	10.4	15	0.87
RONICS BOUTIQUE HOLOINGS ELBO ⁽¹¹⁾	217.7	21	708.2	38	0.6	NM	18.4	58	0.3	NM	8.3	33	0.73
Y DOLLAR STORES FDO ⁽⁴⁾	1022.1	15	2127.2	11	61.1	14	124.8	10	6.0	6.0	18.6	26	1.21
NAL FAST	233.5	13	448.1	9	21.1	11	38.8	-2	9.0	9.2	15.0	42	0.92
ATED DEPARTMENT STORES FD ⁽¹¹⁾	3453.0**	-3	8585.0	-6	89.0	53	399.0	-13	2.6	1.6	9.7	14	2.73
LINE FINL ⁽¹⁰⁾	170.6	6	372.1	5	3.7	219	12.7	NM	2.2	0.7	8.4	17	0.85
Y ENTERPRISES FNLY ⁽¹¹⁾	187.4	-3	575.4	-6	-0.4	NM	24.2	-12	NM	NM	13.9	8	1.98
OCKER Z ⁽¹¹⁾	1090.0	2	2245.0	-4	38.0	19	80.0	8	3.5	3.0	11.4	13	0.80
TAR FTS	593.1	-9	1146.9	-2	5.3	-67	-0.8	NM	0.9	2.5	-12.5	NM	-1.80
FRED ⁽¹¹⁾	258.4	25	532.4	18	6.3	51	14.5	42	2.4	2.0	9.5	32	0.87
PS ⁽¹¹⁾	2890.8	-9	6980.5	-10	36.7	-68	2.5	-99	1.3	3.6	-2.8	NM	-0.11
SPORTS GRTS ⁽¹¹⁾	245.0	51	561.0	42	2.6	328	10.3	-17	1.1	0.4	7.2	24	0.88
CO GCO ⁽¹¹⁾	190.6	11	413.2	7	8.2	-2	24.0	16	4.3	4.9	23.2	13	1.53
S FAMILY CLOTHING GDYS ⁽¹¹⁾	283.5	8	646.6	-3	5.6	NM	-2.1	NM	2.0	NM	-6.2	NM	-0.40
CHALKS GOT ⁽¹¹⁾	152.8	-5	396.0	-6	-2.7	NM	8.2	41	NM	NM	2.4	11	0.22
DEPOT HD ⁽¹¹⁾	14282.0	17	27770.0	23	856.0	35	1566.0	43	6.0	5.2	17.1	21	1.38
N STORES JAS.A ⁽¹¹⁾	372.4	13	870.6	5	8.7	NM	27.6	NM	2.3	NM	0.1	NM	-0.05
T KM ⁽¹¹⁾	7639.0	-8	18517.0	-7	-1449.0	NM	-3191.0	NM	NM	NM	NM	NM	-7.61
S KSS ⁽¹¹⁾	1870.6	26	4594.8	24	106.6	42	340.4	34	5.7	5.0	17.9	42	1.53
ENO LE ⁽¹¹⁾	341.2	10	937.2	10	16.5	182	62.4	66	4.8	1.9	18.6	NA	2.56
O BRANDS LTD ⁽¹¹⁾	2027.0	-5	5165.0	-9	50.0	61	377.0	40	2.5	1.5	12.0	14	1.22
S LOW ⁽¹¹⁾	6470.6	23	11724.1	19	345.8	54	564.2	54	5.3	4.3	16.2	24	1.46
EPARTMENT STORES MAY ⁽¹¹⁾	3169.0**	1	7816.0	-4	70.0	-36	501.0	-20	2.2	3.5	16.8	14	2.11
WEARHOUSE MW ⁽¹¹⁾	303.9	0	689.6	-8	10.5	-18	26.8	-48	3.4	4.2	7.8	21	0.99
ELS STORES MIK ⁽¹¹⁾	603.2	15	1511.2	13	20.7	184	84.2	47	3.4	1.4	12.5	22	1.56
N MARCUS GROUP NMGA ⁽⁵⁾	692.7**	-1	1600.8	-1	47.0	23	71.3	-9	6.8	5.5	7.0	18	1.53
NTS ONLY STORES NDN	167.9	23	331.0	27	13.5	24	26.0	24	8.1	8.0	16.0	31	0.76
TROM JWN ⁽¹¹⁾	1279.1**	2	2939.2	0	-11.2	NM	39.5	-24	NM	2.0	6.9	32	0.57
DEPOT ODP	2644.3	4	5684.9	2	56.9	36	159.7	62	2.2	1.6	12.3	15	0.83
MAX OMX ⁽¹¹⁾	1180.6	-1	2455.0	-6	63.5	NM	-179.6	NM	5.4	NM	-29.8	NM	-2.00
LY AUTOMOTIVE ORLY	343.2	22	638.7	23	22.5	25	39.2	29	6.6	6.4	12.5	19	1.41
C SUNWEAR OF CALIFORNIA PSUN ⁽¹¹⁾	161.7	17	369.3	16	3.3	234	17.4	16	2.0	0.7	11.8	21	0.91
SS SHOESOURCE PSS ⁽¹¹⁾	738.2	-4	1380.5	-6	23.9	20	-10.1	NM	3.2	3.9	7.8	26	1.71
NNECTION PCCC	292.2	-2	528.3	-12	0.3	-77	-1.8	NM	0.1	0.5	1.1	81	0.06
LL MALL	204.9	19	396.5	7	0.5	-22	0.8	-55	0.2	0.3	9.8	8	0.34
Y (J.C.) JCP ⁽¹¹⁾	7728.0	3	17270.0	1	86.0	110	181.0	NM	1.1	0.5	2.2	37	0.47
JYS-MANNY, MOE & JACK PBY ⁽¹¹⁾	559.0	1	1067.2	-3	13.6	49	17.3	66	2.4	1.7	6.5	16	0.78
ANIMAL SUPPLIES PETC ⁽¹¹⁾	349.2	15	712.9	10	-7.2	NM	-18.1	NM	NM	NM	NM	16	1.32
IART PETM ⁽¹¹⁾	645.8	11	1383.6	16	22.1	NM	51.8	NM	3.4	0.1	11.4	30	0.47
SMART PSMT ⁽⁴⁾	162.7	36	336.4	38	1.4	NM	3.1	50	0.8	NM	3.0	48	0.65
STORES ROST ⁽¹¹⁾	819.6	22	1668.0	15	47.7	37	97.6	22	5.8	5.1	29.8	18	2.08
SKS ⁽¹¹⁾	1426.2**	-3	3338.2	-7	19.8	25	74.1	4	1.4	1.1	-0.5	NM	-0.10
ROEBUCK S	10142.0	0	19179.0	1	420.0	NM	738.0	NM	4.1	NM	24.5	10	4.61
IN-WILLIAMS SHW	1453.2	3	2602.4	1	107.5	19	142.3	12	7.4	6.4	21.8	15	1.80
CO STORES SKO ⁽¹¹⁾	731.9	-7	1738.5	-10	0.5	NM	35.4	NM	0.1	NM	4.7	15	1.14
S AUTHORITY TSA ⁽¹¹⁾	354.5	4	756.2	0	1.7	NM	17.3	153	0.5	NM	12.7	13	0.60
STORES STGS ⁽¹¹⁾	206.7	6	475.3	-2	17.8	181	33.6	NM	8.6	3.2	0.0	NA	NA
ES SPLS ⁽¹¹⁾	2744.8	3	5674.0	-2	93.9	138	187.7	NM	3.4	1.5	14.5	23	0.69
TS TLB ⁽¹¹⁾	391.3**	-2	824.5	-6	35.0	-13	67.5	-8	8.9	10.0	20.9	14	1.96
T TGT ⁽¹¹⁾	9594.0**	15	22831.0	11	345.0	36	1008.0	25	3.6	3.0	17.9	21	1.60
Y TIF ⁽¹¹⁾	347.1**	3	912.9	0	32.7	6	115.5	0	9.4	9.1	16.2	20	1.17
X ⁽¹¹⁾	2665.7	17	5874.4	17	147.1	19	302.4	17	5.5	5.4	40.8	18	1.02
JO ⁽¹¹⁾	158.6	16	350.4	9	5.8	53	30.7	25	3.7	2.8	30.4	20	1.29
R' US TOY ⁽¹¹⁾	2095.0	2	6854.0	0	-4.0	NM	154.0	-34	NM	NM	2.3	35	0.39
OR SUPPLY TSCO	392.0	47	585.9	36	17.3	11	13.3	-3	4.4	5.8	12.8	21	2.67
CITY DEPARTMENT STORES VCD ⁽¹¹⁾	588.1	10	1227.8	2	-2.7	NM	-11.4	NM	NM	NM	-10.8	NM	-0.70
HART STORES WMT ⁽¹¹⁾	54960.0	14	119170.0	14	1652.0	20	3840.0	13	3.0	2.9	19.4	30	1.55
EAL WTSLA ⁽¹¹⁾	156.6	14	338.1	8	8.7	63	24.0	32	5.6	3.9	15.8	16	1.12
S WIKS	234.6	-14	420.4	-8	2.3	138	-1.5	NM	1.0	0.4	-12.0	NM	-0.37
LC ⁽⁵⁾	444.4	6	1336.9	4	7.7	120	102.6	37	1.7	0.8	10.8	10	2.92
ELECTRICAL & ELECTRONICS													
STRY COMPOSITE	44586.9	-2	86826.7	-10	-2965.1	NM	-3346.1	NM	NM	NM	-11.1	NM	-0.75
ELECTRICAL PRODUCTS													
P COMPOSITE	4402.4	11	8453.6	8	265.3	262	478.4	79	6.0	1.8	11.6	18	1.60
Y BRANOS AYI ⁽⁴⁾	507.6	1	975.8	0	14.6	94	25.1	22	2.9	1.5	11.0	NA	NA
K AME	267.4	2	531.0	1	21.3	14	41.0	11	8.0	7.1	19.8	15	2.10

CORPORATE SCOREBOARD

COMPANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE-EARNINGS RATIO 7-25
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %		
GENLYTE GROUP GLYT	247.8	-4	479.8	-4	10.7	17	19.4	15	4.3	3.6	14.6	12
HUBBELL HUBB	414.1	21	715.8	4	30.8	41	50.3	17	7.4	6.4	7.4	30
REGAL-BELOIT RBC	154.9	-10	305.3	-13	7.0	33	12.8	15	4.5	3.1	5.7	20
ROCKWELL AUTOMATION ROK (3)	995.0	-3	1953.0	-11	90.0	NM	148.0	236	9.0	NM	12.0	17
SMITH (A.O.) AOS	386.3	25	758.2	21	18.0	68	30.1	57	4.7	3.5	4.2	30
SPX SPW	1257.5	38	2388.0	50	58.3	335	123.4	153	4.6	1.5	14.0	16
WOODWARD GOVERNOR WGOV (3)	171.9	-6	346.8	-2	14.6	6	28.2	7	8.5	7.5	16.4	10
(B) ELECTRONICS												
GROUP COMPOSITE	12424.0	-4	23660.7	-9	-2452.0	NM	-3045.6	NM	NM	NM	-24.0	NM
ANREW ANDW (3)	214.9	-12	414.6	-14	2.0	-84	5.3	-74	0.9	5.0	4.5	21
ARRIS GROUP ARRS	194.1	10	385.7	-1	-40.7	NM	-42.6	NM	NM	NM	-45.9	NM
AVAYA AV (3)	1219.0	-29	2498.0	-30	-37.0	NM	-100.0	NM	NM	1.4	-45.9	NM
CHECKPOINT SYSTEMS CKP	160.9	-1	304.4	-7	6.0	-3	10.1	4	3.7	3.8	2.5	48
HARRIS HRS (6)	497.6	-6	980.9	-3	26.6	-9	49.1	22	5.3	5.5	7.2	26
HUGHES ELECTRONICS GMH	2209.7	11	4247.9	10	-155.1	NM	-311.5	NM	NM	NM	-8.2	NM
L-3 COMMUNICATIONS HOLDINGS LLL	955.2	70	1652.0	61	41.5	78	70.8	89	4.3	4.1	7.1	25
MOTOROLA MOT	6741.0	-10	12762.0	-16	-2321.0	NM	-2770.0	NM	NM	NM	-49.0	NM
UTSTARCOM UTSI	231.5	65	415.2	60	25.7	110	43.3	100	11.1	8.8	10.3	23
(C) INSTRUMENTS												
GROUP COMPOSITE	4777.1	-16	9227.9	-22	-37.6	NM	-190.1	NM	NM	5.6	-5.1	NM
AGILENT TECHNOLOGIES A (2)	1457.0	-39	2883.0	-42	-247.0	NM	-564.0	NM	NM	3.7	-24.0	NM
APPLIED BIOSYSTEMS GROUP ABI (6)	417.3	3	826.3	-2	38.2	-20	87.3	-17	9.2	11.8	14.4	20
DANAHER DHR	1146.3	20	2150.5	10	103.7	10	186.4	5	9.0	9.9	11.2	29
MILLIPORE MIL	176.1	5	342.8	4	22.4	9	42.0	52	12.7	12.2	33.4	18
PERKINELMER PKI	335.7	4	637.3	-1	3.7	-82	-16.1	NM	1.1	6.6	-4.5	NM
TEKTRONIX TEK (7)	208.5	-32	412.1	-35	4.8	-86	15.2	-80	2.3	11.5	3.3	50
TERADYNE TER	309.9	-15	557.9	-43	-50.7	NM	-127.9	NM	NM	NM	-20.5	NM
THERMO ELECTRON TMO	509.1	-6	1000.4	-10	49.5	425	113.9	264	9.7	1.7	6.6	21
WATERS WAT	217.2	5	417.5	2	37.9	-4	73.1	-6	17.5	19.0	16.2	25
(D) SEMICONDUCTORS & OTHER COMPONENTS												
GROUP COMPOSITE	22983.3	0	45484.4	-11	-740.7	NM	-588.8	NM	NM	NM	-10.1	NM
ADVANCED MICRO DEVICES AMD	600.3	-39	1502.4	-31	-184.9	NM	-194.1	NM	NM	1.8	-11.3	NM
AGERE SYSTEMS AGR.A (3)	560.0	-40	1111.0	-48	-332.0	NM	-551.0	NM	NM	NM	NM	NM
ALTERA ALTR	178.9	-17	350.9	-30	21.7	NM	40.7	NM	12.1	NM	2.5	NM
AMPHENOL APH	270.9	-1	526.8	-11	20.0	-11	37.2	-27	7.4	8.2	44.1	23
ANALOG DEVICES ADI (2)	413.4	-31	806.3	-41	14.4	-86	39.1	-87	3.5	17.0	3.5	89
ATMEL ATML	314.8	-14	590.5	-34	-478.9	NM	-523.3	NM	NM	NM	-95.6	NM
AVX AVX (9)	294.9	-19	570.0	-41	1.3	-96	-0.8	NM	0.4	8.1	-2.4	NM
BENCHMARK ELECTRONICS BHE	404.4	27	733.6	-2	8.3	NM	13.6	351	2.0	NM	-9.2	NM
BROADCOM BRCM	258.2	22	497.0	-5	-129.4	NM	-295.5	NM	NM	NM	-68.1	NM
CYPRESS SEMICONDUCTOR CY	202.1	9	395.3	-12	-28.1	NM	-67.9	NM	NM	NM	-56.7	NM
FAIRCHILD SEMICONDUCTOR INTL. FCS	360.5	-3	697.4	-8	-13.0	NM	-10.3	NM	NM	NM	-3.8	NM
INTEL INTC	6319.0	0	13100.0	1	446.0	128	1382.0	103	7.1	3.1	5.6	58
JABIL CIRCUIT JBL (4)	850.6	-19	1672.7	-26	20.8	11	24.5	-59	2.4	1.8	2.9	73
LSI LOGIC LSI	437.8	-6	850.3	-13	-62.3	NM	-234.0	NM	NM	NM	-38.0	NM
MICROCHIP TECHNOLOGY MCHP (9)	159.7	15	308.6	6	21.7	0	48.0	41	13.6	15.7	8.5	48
MICRON TECHNOLOGY MU (4)	771.2	-6	1417.1	-25	-24.2	NM	-54.6	NM	NM	NM	-13.0	NM
MOLEX MOLX (6)	456.3	-11	864.6	-22	27.3	152	47.0	-34	6.0	2.1	4.2	70
NATIONAL SEMICONDUCTOR NSM (7)	419.5	5	789.0	-10	17.1	NM	-20.7	NM	4.1	NM	-6.8	NM
NVIDIA NVDA (11)	582.9	142	1086.6	136	83.2	212	159.3	172	14.3	11.1	27.0	11
ON SEMICONDUCTOR ONNN	277.7	-11	546.8	-19	-25.3	NM	-75.3	NM	NM	NM	NM	NM
PLEXUS PLXS (3)	234.7	-7	465.9	-13	0.7	-91	-1.5	NM	0.3	2.9	0.8	NM
SANMINA-SCI SANM (3)	2617.6	237	5028.9	156	-5.0	NM	-44.3	NM	NM	3.9	-4.3	NM
SOLETRON SLR (4)	3032.8	-24	6007.4	-36	-287.0	NM	-444.1	NM	NM	NM	-10.1	NM
STONERIDGE SRI	172.0	13	329.8	7	10.4	577	16.0	248	6.1	1.0	7.0	27
TEXAS INSTRUMENTS TXN	2162.0	6	3989.0	-13	95.0	NM	57.0	73	4.4	NM	-1.6	NM
THOMAS & BETTS TNB	341.3	-11	683.3	-13	0.4	NM	-11.3	NM	0.1	NM	-21.9	NM
XILINX XLNX (9)	289.9	0	563.4	-19	41.0	122	75.3	NM	14.1	6.4	-4.8	NM
10 FOOD												
INDUSTRY COMPOSITE	86148.8	5	166410.6	3	3110.1	56	6000.2	39	3.6	2.4	15.1	20
(A) FOOD DISTRIBUTION												
GROUP COMPOSITE	7866.3	-11	14492.9	-10	95.4	41	146.3	NM	1.2	0.8	10.8	14
INTERNATIONAL MULTIFOODS IMC (10)	779.6	17	1548.5	15	4.9	135	9.8	104	0.6	0.3	5.2	39
NASH FINCH NAFC	937.1**	-1	1857.9	0	8.1	53	13.9	63	0.9	0.6	12.2	11
SUPERVALU SVU (10)	5849.2	-16	10500.6	-15	77.2	35	112.1	NM	1.3	0.8	11.3	12
UNITED NATURAL FOODS UNFI (5)	300.4	16	585.8	16	5.3	61	10.5	78	1.8	1.3	11.1	20

ORATE SCOREBOARD

ANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE- EARNINGS RATIO 7-25	12 MONTHS' EARNINGS PER SHARE
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %			
FOOD PROCESSING													
COMPOSITE	39172.7	11	76985.4	10	2033.2	72	3948.5	43	5.2	3.4	14.6	22	1.43
DANIELS MIDLAND AOM ⁽⁶⁾	7068.8	32	12395.2	18	112.3	100	229.5	54	1.6	1.1	7.9	15	0.78
BG	3103.0	15	5787.0	12	50.0	117	86.0	353	1.6	0.9	13.9	9	2.27
ELL SOUP CPB ⁽⁵⁾	1371.0	8	3181.0	5	96.0	-21	299.0	-24	7.0	9.6	652.5	18	1.27
EA FOODS CAG ⁽⁷⁾	6413.5	0	12658.2	-1	192.2	58	363.0	53	3.0	1.9	18.2	16	1.47
RODUCTS INTERNATIONAL CPO	486.2	1	918.2	-2	18.6	22	29.9	7	3.8	3.2	7.1	16	1.64
DO DOL	1118.2	-1	2177.6	1	66.8	101	123.1	96	6.0	3.0	2.5	75	0.38
'S GRAND ICE CREAM ORYR	376.8	12	667.2	16	11.7	66	13.0	398	3.1	2.1	8.7	NM	0.52
L MILLS GIS ⁽⁷⁾	2324.0	76	5428.5	80	57.0	-61	139.5	-54	2.5	11.1	12.9	29	1.35
H.J.) HNZ ⁽⁸⁾	2574.4	5	5125.7	8	223.5	NM	425.2	323	8.7	NM	60.7	15	2.36
Y FOODS HSY	823.5	1	1812.0	0	63.1	20	150.2	14	7.7	6.4	17.5	48	1.64
L FOODS HRL ⁽²⁾	954.6	-1	1937.6	5	32.7	-16	83.1	3	3.4	4.0	17.6	17	1.32
TATE BAKERIES IBC ⁽⁷⁾	833.0	2	1886.5	2	22.0	46	38.7	70	2.6	1.9	23.2	19	1.36
FOODS KFT	7513.0	1	14660.0	0	901.0	78	1594.0	92	12.0	6.8	10.6	24	1.53
MICK MKC ⁽¹⁾	552.6	4	1071.5	4	33.6	26	67.5	27	6.1	5.0	29.7	21	1.15
M'S PRIDE CHX ⁽³⁾	637.1	-1	1237.9	4	3.3	-87	4.5	-71	0.5	3.9	7.9	14	0.76
SON FARMS SAFM ⁽²⁾	175.4	7	339.9	8	7.7	54	13.0	141	4.4	3.1	24.6	7	2.61
IELO FOODS SFO ⁽⁸⁾	1963.1	30	4049.4	33	24.9	-53	79.5	-41	1.3	3.5	14.7	9	1.78
ER (J.M.) SJM ⁽⁸⁾	176.1	9	344.5	9	6.7	-10	14.6	9	3.8	4.6	11.0	27	1.24
Y (WM.) JR. WWY	708.5	15	1307.5	11	110.0	10	195.3	8	15.5	16.2	28.9	30	1.68
FOOD RETAILING													
COMPOSITE	39109.8	2	74932.3	0	981.5	33	1905.4	23	2.5	1.9	17.2	15	1.47
SON'S ABS ⁽¹¹⁾	8921.0	-1	18581.0	0	222.0	21	512.0	27	2.5	2.0	9.3	22	1.32
FOOD CENTERS EGLE ⁽¹¹⁾	161.7	0	347.0	-5	-3.7	NM	-3.3	NM	NM	NM	-55.0	NM	-1.98
AMA FSM ⁽²⁾	235.2	5	487.3	5	0.2	-81	1.5	-32	0.1	0.4	9.1	13	2.89
R KR ⁽¹¹⁾	15667.0	4	27796.0	0	381.0	25	731.1	9	2.4	2.0	29.5	13	1.37
ARK STORES PTMK ⁽¹¹⁾	976.8	0	1979.3	-3	2.8	NM	-52.5	NM	0.3	NM	-50.0	NM	-5.82
RAFFIC PNFT ⁽¹¹⁾	576.4	0	1191.3	-4	1.1	NM	-19.0	NM	0.2	NM	-45.7	NM	-3.36
OK ROK ⁽³⁾	666.3	-5	1325.8	-5	16.5	NM	25.2	NM	2.5	NM	10.2	16	1.03
AY SWY	8081.3	1	16013.6	2	309.3	1	641.4	8	3.8	3.8	24.4	10	2.60
EN SE	2639.5**	2	4846.5	0	34.3	2	32.0	-13	1.3	1.3	58.8	10	0.79
& FINAL SMF	476.1	3	921.0	4	2.1	-43	2.6	-37	0.4	0.8	4.3	16	0.40
E SUPER MARKET VLGEA ⁽⁵⁾	216.5	9	447.2	9	2.3	115	6.1	65	1.1	0.5	13.0	7	3.92
MARKETS WMK	491.9	1	996.3	2	13.6	56	28.3	9	2.8	1.8	9.9	17	1.93
FUEL													
TRY COMPOSITE	80468.2	-6	148294.1	-14	2401.6	-68	4178.2	-73	3.0	8.8	5.0	38	0.97
COAL, OIL & GAS													
COMPOSITE	68881.2	-5	125493.1	-15	2216.7	-67	3417.3	-76	3.2	9.3	4.0	45	0.91
DA HESS AHC	2796.0	-19	5818.0	-24	149.0	-58	289.0	-58	5.3	10.3	10.3	11	5.72
ARKO PETROLEUM APC	1738.0	-22	3111.0	-41	241.0	-40	330.0	-69	13.9	18.0	-14.6	NM	-3.73
E APA	641.7	-19	1163.5	-27	146.3	-29	227.0	-53	22.8	25.8	10.6	16	3.18
COAL ACI	374.7	3	741.9	0	2.1	145	-5.3	NM	0.6	0.2	-0.9	NM	-0.09
ND ASH ⁽³⁾ †	2059.0	-1	3675.0	-2	65.0	-67	44.0	-80	3.2	9.5	9.2	12	2.93
NGTON RESOURCES BR	769.0	-17	1452.0	-30	170.0	-26	218.0	-61	22.1	24.9	6.1	33	1.05
ONTEXACO CVX	23472.0	-14	42628.0	-22	407.0	-81	1132.0	-75	1.7	7.7	1.5	NM	0.49
O COC	7667.0	-12	13936.0	-22	132.0	-76	214.0	-82	1.7	6.3	8.9	21	1.01
L ENERGY CNX	536.3**	-15	1088.3	-14	9.0	-82	14.5	-90	1.7	7.8	6.4	60	0.19
HOC ⁽⁵⁾	210.3	-22	377.1	-32	6.2	-70	5.7	-83	2.9	7.8	20.3	6	2.86
McGEE KMG	932.0	1	1730.5	-12	-127.3	NM	-129.0	NM	NM	18.1	-4.8	NM	-1.52
HON OIL MRO	8083.0	-11	14492.0	-18	194.0	-67	248.0	-77	2.4	6.4	9.8	14	1.56
HY OIL MUR	1134.7	-13	1964.6	-21	13.9	-91	16.5	-94	1.2	12.5	5.8	35	1.90
ELO EXPLORATION NFX	161.6	-19	309.7	-24	16.3	-71	32.6	-73	10.1	28.3	5.1	39	0.75
ENTAL PETROLEUM OXY	3141.0	-18	5666.0	-32	240.0	-49	360.0	-63	7.6	12.3	10.1	17	1.48
PS PETROLEUM P	10367.0	114	18691.0	92	366.0	-41	264.0	-76	3.5	12.8	5.5	19	2.45
PRODUCING PPP	185.2	10	327.6	-3	28.6	-8	37.6	-47	15.4	18.3	6.6	29	0.97
DO SUN	3067.0	-12	5557.0	-17	10.0	-95	-96.0	NM	0.3	5.6	0.0	NM	-0.08
L UCL	1356.0	-20	2394.0	-39	113.0	-52	135.0	-74	8.3	13.9	6.7	36	0.84
ERGY XTO	189.6	-10	370.0	-19	34.6	-62	79.7	-56	18.3	43.2	22.3	11	1.52
PETROLEUM SERVICES													
COMPOSITE	11587.1	-9	22801.0	-6	184.9	-75	760.8	-54	1.6	5.8	8.5	27	1.08
HUGHES BHI	1301.8	-3	2562.7	0	72.4	-31	148.2	-16	5.6	7.8	12.3	25	1.09
VICES BJS ⁽³⁾	439.6	-24	882.0	-22	27.7	-74	66.6	-64	6.3	18.1	17.0	21	1.44
R CAMERON CAM	402.6**	-1	769.5	4	22.7	15	42.2	24	5.6	4.9	10.7	22	1.89
NO OFFSHORE DRILLING OO	179.7	-21	373.3	-14	12.0	-73	34.5	-57	6.7	19.2	7.0	24	0.93
INTERNATIONAL ESV	157.2	-27	299.5	-27	23.3	-62	39.5	-63	14.8	28.4	9.3	24	1.02
BURTON HAL	3235.0	-3	6242.0	-4	-358.0	NM	-308.0	NM	NM	4.3	0.3	NM	0.04
IS INDUSTRIES NBR	346.1	-42	722.0	-36	25.4	-76	67.4	-64	7.3	17.3	10.5	19	1.49

CORPORATE SCOREBOARD

COMPANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE-EARNINGS RATIO 7-25
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %		
NOBLE NE	247.4	0	482.9	3	57.4	-16	108.9	-11	23.2	27.6	13.6	16
NOBLE ENERGY NBL	333.9	-19	649.0	-33	17.1	-67	2.0	-99	5.1	12.4	-2.1	NM
SCHLUMBERGER SLB	3388.6	-10	6697.9	-1	196.0	NM	368.5	158	5.8	NM	8.8	31
SMITH INTERNATIONAL SII	801.0	-8	1628.4	-6	26.9	-29	55.7	-23	3.4	4.3	13.3	21
TIOEWATER TDW ⁽⁹⁾	160.3	-16	329.7	-10	23.0	-41	51.3	-25	14.4	20.5	9.2	12
WEATHERFORD INTERNATIONAL WFT	593.9	4	1162.1	6	38.9	-31	84.1	-16	6.5	9.8	10.2	23
12 HEALTH CARE												
INDUSTRY COMPOSITE	127490.5	11	250416.7	10	13217.9	13	26940.1	18	10.4	10.1	24.1	24
(A) DRUG DISTRIBUTION												
GROUP COMPOSITE	26576.8	15	52790.2	13	418.3	212	656.7	NM	1.6	0.6	8.8	49
LONGS DRUG STORES LDG ⁽¹¹⁾	1089.8	6	2303.2	8	11.0	-5	32.7	67	1.0	1.1	6.6	19
McKESSEN MCK ⁽⁹⁾	13628.0	17	26619.2	15	117.3	11	242.7	NM	0.9	0.9	10.5	21
NU SKIN ENTERPRISES NUS	244.9	12	461.0	7	18.0	56	30.9	28	7.4	5.3	15.3	13
PRIORITY HEALTHCARE PHCC	291.0	45	557.5	51	10.7	249	20.3	72	3.7	1.5	12.8	25
RITE AID RAD ⁽¹⁰⁾	3925.1	6	7963.0	2	2.3	NM	-255.6	NM	0.1	NM	NM	NM
WALGREEN WAG ⁽⁴⁾	7397.9	17	14886.4	17	259.0	21	585.6	15	3.5	3.4	16.5	35
(B) DRUGS & RESEARCH												
GROUP COMPOSITE	46062.3	5	90598.6	5	8055.8	-2	16714.9	6	17.5	18.7	28.0	22
ABBOTT LABORATORIES ABT	4314.9	5	8504.2	11	592.3	12	1446.5	374	13.7	12.9	28.5	22
ALLERGAN AGN	484.4	12	926.1	8	3.8	-83	47.6	-37	0.8	5.1	23.4	37
AMGEN AMGN	1249.1	27	2257.6	20	412.4	28	753.3	20	33.0	32.6	25.5	36
BIOGEN BGEN	269.3	3	557.6	12	43.4	-40	115.5	-20	16.1	27.6	16.5	21
BRISTOL-MYERS SQUIBB BMY	4053.0	-14	8135.0	-13	440.0	-60	1025.0	-56	10.9	23.4	11.2	34
CHIRON CHIR [†]	271.9	14	505.3	5	50.4	49	31.5	-60	18.6	14.2	6.4	45
FOREST LABORATORIES FRX ⁽⁹⁾	467.2**	33	903.9	34	123.8	67	220.4	54	26.5	21.1	23.9	34
GENENTECH DNA	622.3**	29	1207.5	22	-213.6	NM	-118.3	NM	NM	8.0	-0.6	NM
GENZYME GENERAL GENZ	267.2	12	509.3	10	49.6	41	80.4	13	18.6	14.7	2.0	99
LILLY (ELI) LLY	2775.2	-9	5336.3	-9	658.5	-20	1287.7	-21	23.7	27.3	32.0	23
MERCK MRK	12809.7	8	24979.0	7	1750.7	-4	3375.7	-3	13.7	15.3	43.7	14
NBTY NBTY ⁽³⁾	252.0	24	503.5	1	29.7	122	55.3	77	11.8	6.6	20.1	13
PFIZER PFE	8033.0	5	16452.0	8	1957.0	9	4330.0	16	24.4	23.5	42.5	21
PHARMACIA PHA	3553.0	4	6680.0	1	882.0	111	1275.0	104	24.8	12.2	12.4	29
SCHERING-PLOUGH SGP	2833.0	8	5389.0	9	633.0	0	1232.0	3	22.3	24.2	26.7	17
SIGMA-ALORICH SIAL	304.3	10	605.9	7	42.9	7	85.5	8	14.1	14.5	17.3	23
WYETH WYE	3502.8	10	7146.4	8	599.9	26	1471.8	22	17.1	15.0	53.5	18
(C) HEALTH-CARE SERVICES												
GROUP COMPOSITE	34842.3	16	67941.9	16	1783.9	65	3457.7	53	5.1	3.6	19.5	22
ADVANCEPCS ADVP ⁽⁹⁾	3592.2	14	7031.1	15	36.8	48	71.8	153	1.0	0.8	14.5	16
APRIA HEALTHCARE GROUP AHG	310.4	10	611.8	10	26.2	52	49.2	43	8.4	6.1	30.5	14
CAREMARK RX CMX	1626.5	18	3240.6	18	72.5	71	135.0	67	4.5	3.1	NM	16
COMMUNITY HEALTH SYSTEMS CYH	530.6	32	1064.1	33	24.2	151	51.4	151	4.6	2.4	6.8	28
EXPRESS SCRIPTS ESRX	3402.6	51	6151.7	42	48.7	61	92.7	59	1.4	1.3	16.9	23
HCA HCA	4903.0	10	9776.0	9	350.0	33	735.0	25	7.1	5.9	18.2	23
HEALTH MANAGEMENT ASSOCIATES HMA ⁽³⁾	592.5	25	1172.4	23	66.6	23	135.9	32	11.2	11.4	18.1	20
HEALTH NET HNT	2506.0	-2	4975.8	-1	64.7	NM	123.5	338	2.6	NM	14.9	15
LABORATORY CORP. OF AMERICA HOLDINGS LH	612.4	11	1202.4	12	78.5	51	144.3	51	12.8	9.5	19.7	17
LIFEPOINT HOSPITALS LPNT	177.9	17	359.5	18	13.1	54	27.6	61	7.4	5.6	14.4	27
LINCARE HOLDINGS LNCR	234.5	18	463.0	19	46.5	32	91.7	37	19.8	17.8	19.6	21
QUEST DIAGNOSTICS DGX	1068.8	15	2015.6	11	87.2	85	153.8	86	8.2	5.1	16.2	21
SIERRA HEALTH SERVICES SIE	364.0**	14	712.5	15	10.5	179	17.9	147	2.9	1.2	23.6	23
TENET HEALTHCARE THC ⁽⁷⁾	3738.0	16	7222.0	16	321.0	113	609.0	74	8.6	4.7	18.2	22
UNITEDHEALTH GROUP UNH	6078.0**	5	12091.0	5	325.0	46	620.0	43	5.3	3.8	27.6	26
UNIVERSAL HEALTH SERVICES UHS	805.9**	12	1610.3	15	44.3	37	90.0	31	5.5	4.5	13.6	23
WELLPOINT HEALTH NETWORKS WLP	4299.1**	37	8242.1	43	168.0	68	309.1	57	3.9	3.2	14.8	20
(D) MEDICAL PRODUCTS												
GROUP COMPOSITE	20009.1	11	39086.0	11	2959.9	34	6110.7	28	14.8	12.3	21.8	27
BARO (C.R.) BCR	317.5	7	619.4	7	43.9	25	78.6	15	13.8	11.8	18.8	17
BAUSCH & LOMB BOL	458.4	14	872.6	9	21.8	221	30.7	448	4.8	1.7	7.1	25
BAXTER INTERNATIONAL BAX	2022.0	8	3972.0	10	200.0	-21	453.0	-3	9.9	13.5	16.5	34
BECTON, DICKINSON BDx ⁽³⁾	998.5	6	2011.4	6	119.7	1	248.9	7	12.0	12.5	20.1	15
BIOMET BMET ⁽⁷⁾	325.9	13	630.5	14	60.6	3	122.3	26	18.6	20.5	19.4	28
BOSTON SCIENTIFIC BSX	708.0	5	1383.0	4	25.0	NM	107.0	NM	3.5	NM	11.0	50
CONTECH INTERNATIONAL XRAY	378.0	48	729.2	46	36.8	34	69.9	13	9.7	10.8	17.7	23
EDWARDS LIFESCIENCES EW	172.8	10	335.1	-13	30.6	NM	51.4	NM	17.7	NM	17.3	17
GUIDANT GDT	807.0	23	1516.7	14	204.8	78	344.3	52	25.4	17.6	30.1	16
INVACARE IVC	271.8	2	526.9	1	16.1	0	28.0	1	5.9	6.0	8.3	28
JOHNSON & JOHNSON JNJ	9073.0	11	17816.0	11	1654.0	12	3488.0	15	18.2	18.1	25.8	24
MEOTRONIC MDT ⁽⁸⁾	1791.5	18	3383.9	18	300.9	101	615.8	36	16.8	9.9	16.0	46

CORPORATE SCOREBOARD

COMPANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE-EARNINGS RATIO 7-25	12 MONTHS EARNINGS PER SHARE
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %			
MINOR OMI	979.6	3	1946.2	4	11.5	22	22.3	30	1.2	1.0	13.8	16	0.95
E MEDICAL STJ	404.3	20	775.5	17	69.6	59	131.6	45	17.2	13.0	15.3	31	1.18
STE (9)	221.4	12	465.9	12	12.8	193	31.4	NM	5.8	2.2	11.1	25	0.77
R SYK	733.9	15	1436.8	13	85.9	31	167.0	29	11.7	10.3	23.4	31	1.52
R HOLOINGS ZMH	345.6	17	664.7	15	65.9	53	120.5	52	19.1	14.7	93.1	35	0.98
HOUSING & REAL ESTATE													
TRY COMPOSITE	23168.8	11	43042.7	10	948.3	-23	1731.9	-7	4.1	5.9	13.7	15	2.32
BUILDING MATERIALS													
P COMPOSITE	9604.3	-1	17323.6	-2	97.7	-81	169.1	-69	1.0	5.3	9.6	30	1.45
CAN STANOARO ASD	2087.0	2	3848.0	0	126.0	5	183.0	-1	6.0	5.9	293.0	18	3.98
S SUPPLY HUG (11)	790.0	2	1456.2	-4	12.4	93	17.6	NM	1.6	0.8	8.2	16	2.13
E NORTH AMERICA LAF	891.7	-4	1341.4	-2	107.0	24	53.7	160	12.0	9.3	13.7	9	3.65
X INTERNATIONAL LII	830.6	-2	1506.4	-4	25.6	NM	26.2	NM	3.1	NM	0.2	NM	-0.01
K NTK	522.2	5	951.3	7	23.5	37	33.0	90	4.5	3.5	15.0	11	4.16
DUSTRIES PPG	2134.0	-1	4009.0	-6	-345.0	NM	-302.0	NM	NM	7.2	-4.6	NM	-0.74
AR VAL (2)	554.0	8	985.0	16	34.5	81	47.1	101	6.2	3.7	10.8	26	1.48
N MATERIALS VMC	747.7	-10	1334.8	-8	65.4	-18	77.0	-10	8.7	9.6	13.2	18	2.09
INTERNATIONAL YRK	1047.1	-3	1891.5	-6	48.2	47	33.5	41	4.6	3.0	8.6	21	1.39
CONSTRUCTION & REAL ESTATE													
P COMPOSITE	13564.4	20	25719.1	21	850.6	18	1562.7	20	6.3	6.4	15.4	10	2.80
PROPERTY AM8	157.8	8	318.1	9	28.4	-6	58.9	-21	18.0	20.8	6.7	21	1.29
BAY COMMUNITIES AV8	160.8	-1	320.9	1	37.3	-23	78.1	-22	23.2	29.9	8.8	14	2.91
R HOMES USA 8ZH (3)	743.8	66	1247.1	52	34.6	74	58.8	57	4.7	4.4	14.2	6	10.19
N PROPERTIES 8XP	291.7	14	567.7	16	56.4	13	107.0	3	19.3	19.6	11.8	15	2.29
X CTX (9)	1843.9**	8	4105.0	11	87.8	17	205.2	13	4.8	4.4	18.6	7	6.27
ION ENTERPRISES CH8	361.5	-16	667.9	-11	-8.8	NM	-20.6	NM	NM	0.1	-9.6	NM	-0.49
T CITY ENTERPRISES FCE.A (11)	214.9**	12	466.9	12	10.4	7	23.1	67	4.8	5.0	15.6	14	2.20
N (D.R.) DHI (3)	1808.5	61	3408.6	68	105.9	54	194.8	62	5.9	6.1	16.6	8	2.68
MARRIOTT HMT	925.0	-8	1714.0	-9	24.0	-52	12.0	-85	2.6	5.0	-3.9	NM	-0.19
NIAN ENTERPRISES HOV (2)	561.5**	40	1015.7	46	26.5	88	44.7	113	4.7	3.5	18.7	9	2.87
ME K8H (1)	1139.7	7	2055.3	9	64.1	62	106.7	63	5.6	3.7	22.5	7	5.97
R LEN (1)	1564.9**	13	2806.5	13	106.0	9	177.9	20	6.8	7.0	24.0	8	6.39
HOLOINGS MDC	509.1	0	965.2	4	34.3	-12	66.7	-2	6.7	7.6	21.1	7	5.59
HOTTENSTEIN HOMES MHO	258.4	16	474.0	18	16.9	27	32.8	44	6.5	6.0	19.9	8	4.03
VR	788.4**	19	1480.7	24	83.8	41	160.5	50	10.6	8.9	74.8	9	31.14
HOMES PHM	1685.6**	59	3064.3	61	90.4	49	159.0	59	5.4	5.7	14.7	8	6.09
BROTHERS TOL (2)	549.0**	7	1041.2	6	52.5	15	97.0	13	9.6	8.9	21.9	8	2.98
LEISURE TIME INDUSTRIES													
TRY COMPOSITE	41288.4	7	79249.8	5	2554.1	277	3842.7	NM	6.2	1.8	2.4	52	0.34
EATING PLACES													
P COMPOSITE	9259.9	6	17862.5	6	875.4	24	1518.8	29	9.5	8.1	20.0	18	1.32
VANS FARMS 808E (8)	260.5	5	523.3	5	17.5	48	33.8	45	6.7	4.8	13.6	14	1.91
GROUP C8RL (5)	505.1	8	1027.6	8	20.6	41	41.7	41	4.1	3.1	7.9	25	1.13
CAKE FACTORY CAKE	165.4	25	315.6	25	13.3	30	23.8	28	8.0	7.7	13.2	38	0.89
RESTAURANTS CKR (11)	434.5	-8	735.6	-11	13.2	NM	4.9	NM	3.0	NM	-18.8	NM	-0.69
N RESTAURANTS DRI (7)	1162.4	8	2296.8	11	72.9	20	139.2	26	6.3	5.7	21.1	18	1.30
VALO'S MCD	3862.1	4	7459.5	3	497.5	13	849.2	4	12.9	11.9	17.4	17	1.29
TUESDAY RI (7)	217.5	12	431.2	12	21.2	24	26.3	-26	9.8	8.8	17.4	22	0.88
S FAMILY STEAK HOUSES RYAN	201.5	4	395.5	5	15.4	20	28.8	22	7.7	6.7	16.3	11	1.08
Y'S INTERNATIONAL WEN	684.0	12	1296.4	11	63.7	14	107.2	13	9.3	9.2	18.6	20	1.79
BRANDS YUM	1767.0	10	3381.0	9	140.0	21	264.0	29	7.9	7.2	209.1	16	1.80
ENTERTAINMENT													
P COMPOSITE	18055.4	12	34814.4	9	721.9	NM	926.6	NM	4.0	NM	-1.6	NM	-0.33
ENTERTAINMENT AEN (9)	461.6	49	800.2	34	-0.9	NM	-10.5	NM	NM	NM	-14.3	NM	-1.54
STAR CASINOS ASCA	166.3	13	329.1	12	12.6	42	28.1	118	7.6	6.0	27.6	10	1.93
ME WARNER AOL	10575.0	14	20339.0	11	394.0	NM	393.0	NM	3.7	NM	-2.5	NM	-0.54
Y GAMING AGY	236.3	42	480.1	43	11.3	-18	36.0	27	4.8	8.2	34.8	9	2.50
AZR	211.1	0	417.1	-1	16.5	3	30.2	10	7.8	7.6	12.6	10	1.56
BUSTER 88I	1271.0	4	2597.0	2	41.7	NM	107.7	NM	3.3	NM	-3.0	NM	-0.71
GAMING 8YD	312.0	11	614.8	9	17.0	103	33.1	129	5.5	3.0	11.8	20	0.68
CHILL DOWNS CHDN	172.6	6	203.6	4	23.1	6	11.1	1	13.4	13.4	9.7	23	1.66
AH'S ENTERTAINMENT HET	1030.4	18	2014.0	16	86.1	80	171.3	86	8.4	5.5	20.4	17	2.53
WOOD ENTERTAINMENT HLYW	345.3	6	708.9	6	41.5	511	70.1	580	12.0	2.1	220.6	6	2.78
F CAPRI CASINOS ISLE (8)	305.1	11	567.2	10	-20.1	NM	-12.0	NM	NM	2.9	2.7	NM	0.15
ALAY RESORT GROUP M8G (11) †	638.1**	-5	1177.3	-7	48.9	3	0.7	-99	7.7	7.1	5.8	34	0.77
O-GOLOWYN-MAYER MGM	336.9	23	652.1	5	-121.8	NM	-212.6	NM	NM	NM	-7.7	NM	-0.76
MIRAGE MGG	1020.7	-2	2032.6	-3	101.9	33	183.8	14	10.0	7.4	7.1	27	1.20
ON CASINOS STN	199.6	-6	403.0	-5	8.0	2	21.0	13	4.0	3.7	11.5	24	0.51

CORPORATE SCOREBOARD

COMPANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE- EARNINGS RATIO 7-25
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %		
TICKETMASTER TMCS	212.5	14	398.4	11	14.7	NM	9.8	NM	6.9	NM	-7.6	NM
TRUMP HOTELS & CASINO RESORTS DJT	313.4	4	614.6	5	0.2	NM	-4.3	NM	0.1	NM	-5.9	NM
VAIL RESORTS MTN ⁽⁵⁾	247.5	9	465.3	12	47.3	15	70.2	23	19.1	18.1	5.1	21
(C) HOTEL & MOTEL												
GROUP COMPOSITE	3618.0	2	6876.0	-2	205.0	-14	319.0	-24	5.7	6.7	3.7	48
MARRIOTT INTERNATIONAL MAR	2586.0	6	4950.0	1	129.0	-1	211.0	-16	5.0	5.3	5.2	44
STARWOOD HOTELS & RESORTS HOT	1032.0	-7	1926.0	-9	76.0	-29	108.0	-36	7.4	9.6	2.2	58
(D) OTHER LEISURE												
GROUP COMPOSITE	10355.0	2	19697.0	0	751.8	156	1078.2	158	7.3	2.9	12.5	23
AMERICAN GREETINGS AM ⁽¹⁰⁾	484.2	23	1140.6	8	44.5	NM	31.4	NM	9.2	NM	0.2	NM
BRUNSWICK BC	1017.2	10	1883.9	2	46.2	11	41.5	-49	4.5	4.5	5.4	30
CALLAWAY GOLF ELY	252.2	-1	508.6	-1	37.1	38	67.8	11	14.7	10.6	11.7	15
CARNIVAL CCL ⁽¹⁾	989.2	-8	1894.9	-9	194.2	4	323.8	3	19.6	17.3	13.7	16
EASTMAN KODAK EK	3339.0	-7	6046.0	-8	284.0	689	323.0	74	8.5	1.0	7.3	38
FLEETWOOD ENTERPRISES FLE ⁽⁸⁾	603.2	10	1125.6	6	-40.5	NM	-57.8	NM	NM	NM	-46.5	NM
HARLEY-DAVIDSON HDI	1061.2**	16	2030.8	18	144.3	25	264.3	27	13.6	12.6	25.1	28
HASBRO HAS	546.0	7	998.3	2	-25.9	NM	-42.9	NM	NM	NM	5.5	32
MATTEL MAT	804.4	-4	1546.4	0	19.6	NM	15.6	NM	2.4	NM	22.5	22
POLARIS INDUSTRIES PI	362.6	2	661.8	3	19.9	16	31.5	15	5.5	4.8	37.7	16
THOR INDUSTRIES THO ⁽⁵⁾	369.8	67	639.0	62	16.6	147	24.3	145	4.5	3.0	12.6	20
TRANS WORLD ENTERTAINMENT TWMC ⁽¹¹⁾	279.5	-10	790.5	-8	-6.3	NM	28.2	-26	NM	NM	2.9	21
WINNEBAGO INDUSTRIES WGO ⁽⁴⁾	246.6	26	430.8	27	18.1	45	27.5	48	7.3	6.4	31.7	14
15 MANUFACTURING												
INDUSTRY COMPOSITE	49343.6	2	92027.3	-2	2681.1	20	4248.6	-6	5.4	4.6	9.8	31
(A) GENERAL MANUFACTURING												
GROUP COMPOSITE	18502.2	9	35287.1	5	1230.4	67	2151.2	35	6.7	4.3	17.4	25
AEP INDUSTRIES AEPI ⁽²⁾	161.0	-2	309.6	-4	2.6	NM	7.8	NM	1.6	NM	10.7	37
APOGEE ENTERPRISES APOG ⁽¹⁰⁾	184.7	-9	372.9	-6	5.2	-6	9.6	-2	2.8	2.8	14.8	15
APTARGROUP ATR	233.2	1	451.9	-3	17.5	15	30.8	-8	7.5	6.6	10.5	18
AVERY DENNISON AVY	1056.3	10	1987.1	3	73.8	23	138.6	12	7.0	6.2	24.8	21
BARNES GROUP B	209.4	5	403.6	1	8.7	26	15.4	9	4.1	3.4	9.3	18
BLYTH BTH ⁽¹¹⁾	277.9	8	646.4	10	17.3	10	30.9	15	6.2	6.1	15.1	19
BUTLER MFG. BBR	213.4	0	396.3	-3	0.3	-91	-5.1	NM	0.1	1.6	1.5	66
CARLISLE CSL	552.3	13	1007.4	6	24.7	49	37.6	487	4.5	3.4	9.8	22
FEDERAL SIGNAL FSS	257.9	-10	503.5	-8	10.7	-36	20.5	-28	4.2	5.8	10.8	25
FORTUNE BRANDS FO	1438.5	9	2634.5	5	196.9	91	280.9	71	13.7	7.8	23.2	15
HARSCO HSC	486.6	1	922.8	-4	24.1	-2	38.5	4	5.0	5.1	10.3	15
HEXCEL HXL	221.2	-13	443.3	-16	5.3	NM	-3.9	NM	2.4	NM	NM	NM
INTERNATIONAL GAME TECHNOLOGY IGT ⁽³⁾ †	522.4	63	1052.8	66	81.5	44	155.4	41	15.6	17.7	19.3	17
JOHNSON CONTROLS JCI ⁽³⁾	5257.0	11	10067.5	8	175.3	28	290.1	32	3.3	2.9	19.1	13
MYERS INDUSTRIES MYE	153.1	0	302.0	-5	6.8	114	16.8	51	4.4	2.1	8.5	17
NCI BUILDING SYSTEMS NCS ⁽²⁾	213.2	2	441.8	4	4.8	287	7.9	93	2.3	0.6	7.3	16
OMNOVA SOLUTIONS OMN ⁽¹⁾	175.0	-8	331.3	-7	5.5	NM	6.0	NM	3.1	NM	9.6	20
SAMSONITE SAMC ⁽¹¹⁾	160.5	-16	313.9	-19	-12.1	NM	-37.0	NM	NM	NM	NM	NM
SHAW GROUP SGR ⁽⁴⁾	902.6	129	1468.9	100	26.7	49	48.1	62	3.0	4.5	12.5	11
SHILOH INDUSTRIES SHLO ⁽²⁾	158.7	-8	304.7	-10	-1.8	NM	-7.5	NM	NM	1.0	-35.3	NM
SPARTECH SEH ⁽²⁾	233.2	-7	423.9	-14	9.1	-10	13.9	-25	3.9	4.0	11.0	26
SPS TECHNOLOGIES ST	215.6	-10	423.7	-11	5.6	0	8.7	-50	2.6	2.3	3.6	30
TELEFLEX TFX	546.3	9	1054.7	8	33.5	8	64.0	5	6.1	6.2	13.4	16
3M MMM	4161.0	2	8051.0	-2	466.0	131	918.0	40	11.2	5.0	26.5	28
TUPPERWARE TUP	286.1	0	538.0	-2	32.0	16	47.6	4	11.2	9.7	49.0	16
VALMONT INDUSTRIES VALM	225.1	-3	433.7	-1	10.3	22	17.6	33	4.6	3.6	13.2	15
(B) MACHINE & HAND TOOLS												
GROUP COMPOSITE	3199.7	1	6110.3	-2	181.1	40	301.5	10	5.7	4.1	9.9	26
BLACK & DECKER BDK	1125.3	7	2077.0	3	66.1	59	99.1	32	5.9	4.0	15.6	26
LINCOLN ELECTRIC HOLDINGS LECO	259.7	4	508.1	1	19.7	-10	30.2	-31	7.6	8.7	14.4	14
NACCO INDUSTRIES NC	609.6	-9	1186.1	-14	2.8	-54	9.1	-56	0.5	0.9	-8.6	NM
SNAP-ON SNA	555.0**	4	1073.3	0	29.2	228	50.9	33	5.3	1.7	4.0	46
STANLEY WORKS SWK	649.1	-3	1265.8	-2	63.3	25	112.2	15	9.8	7.5	18.4	18
(C) SPECIAL MACHINERY												
GROUP COMPOSITE	25723.8	-3	47175.8	-7	1191.3	-11	1672.5	-35	4.6	5.1	6.1	40
AGCO AG	772.6	17	1391.2	17	14.1	152	12.0	NM	1.8	0.8	4.5	35
APPLIED MATERIALS AMAT ⁽²⁾	1155.5	-46	2156.9	-52	52.0	-84	6.5	-99	4.5	14.9	0.5	NM
CATERPILLAR CAT	5291.0	-4	9700.0	-6	200.0	-26	280.0	-35	3.8	4.9	11.3	23
CLARCOR CLC ⁽¹⁾	176.5	11	334.8	6	10.6	19	18.6	-1	6.0	5.6	14.3	17
CRANE CR	391.6	-4	763.2	-3	26.6	-18	47.4	-10	6.8	7.9	12.2	16
CUMMINS CUM	1458.0	0	2791.0	-1	13.0	NM	-16.0	NM	0.9	NM	-1.0	NM
DEERE DE ⁽²⁾	3986.5**	5	6508.6	0	141.8	11	103.6	-44	3.6	3.4	-3.5	NM

ORATE SCOREBOARD

ANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE- EARNINGS RATIO 7-25	12 MONTHS EARNINGS PER SHARE
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %			
SON DCI ⁽⁵⁾	269.4	0	533.7	-3	21.5	20	42.2	18	8.0	6.6	23.3	18	1.85
CV	1097.2	-1	2104.7	-9	64.1	31	110.8	-12	5.8	4.4	2.4	58	0.51
RVE FLS	592.7	28	1039.8	14	20.6	692	33.4	NM	3.5	0.6	7.3	14	1.23
	190.4	-1	365.4	-4	15.6	20	27.2	34	8.2	6.7	8.1	25	1.24
TOOL WORKS ITW	2434.6	1	4639.3	-2	265.2	13	459.6	10	10.9	9.7	13.5	22	2.75
ILL-RAND IR	2587.4	5	4893.3	3	107.4	71	188.3	68	4.2	2.6	9.1	19	1.90
STRIES ITT	1320.1	11	2505.9	6	92.9	22	164.4	22	7.0	6.4	16.8	24	2.66
STRIES JLG ⁽⁵⁾	208.7	-5	365.1	-19	0.8	-92	2.2	-86	0.4	4.9	3.0	39	0.24
BAL JOYG ⁽²⁾	289.2	1	575.6	4	1.3	NM	-27.9	NM	0.4	NM	-9.0	NA	NA
SEARCH LRCX ⁽⁶⁾	180.3	-51	344.4	-59	-31.0	NM	-29.5	NM	NM	6.9	-13.3	NM	-0.71
WOC MTW	346.2	16	647.6	23	20.1	12	26.7	-4	5.8	6.0	18.9	16	1.93
R-TOLEDO INTERNATIONAL MTD	296.5	6	569.4	5	27.5	311	46.2	118	9.3	2.4	21.6	12	2.19
IN NDSN ⁽²⁾	163.5	-15	308.5	-16	7.8	-14	13.5	-19	4.8	4.7	7.9	37	0.64
US SYSTEMS NVLS	222.1	-41	391.8	-53	12.0	-80	15.8	-89	5.4	15.7	1.0	NM	0.13
PNR	708.1	3	1311.2	-3	43.0	50	64.4	31	6.1	4.1	6.8	27	1.46
NDUSTRIES ROP ⁽²⁾	153.8	5	303.4	7	17.5	26	32.0	25	11.3	9.4	17.4	16	1.96
T & STEVENSON SERVICES SSSS ⁽¹¹⁾	299.7	-9	606.4	-7	4.9	-77	5.0	-84	1.6	6.4	7.5	14	1.00
TKR	660.8	4	1276.6	-1	4.0	NM	13.1	NM	0.6	NM	-2.0	NM	-0.27
C ⁽²⁾	470.3**	2	748.2	1	38.1	27	33.0	5	8.1	6.5	14.6	12	4.03
COMPOSITES													
COMPOSITE	1917.9	23	3454.2	13	78.3	159	123.4	142	4.1	1.9	14.3	15	1.25
CE IFSIA	240.6	-16	475.0	-20	0.8	-39	0.7	-88	0.3	0.4	-15.5	NM	-0.82
K INDUSTRIES MHK	1227.7	42	2094.5	28	75.5	63	118.7	61	6.2	5.4	12.5	11	4.07
INT STEVENS WXS	449.6	12	884.7	8	2.0	NM	4.0	NM	0.4	NM	NM	16	0.10
METALS & MINING													
TRY COMPOSITE	17400.6	-6	33193.1	-9	362.3	NM	359.5	NM	2.1	NM	-2.7	NM	-0.34
STEEL													
COMPOSITE	8031.5	5	14913.6	1	70.4	NM	-199.8	NM	0.9	NM	-15.1	NM	-1.61
EL HOLDING AKS	1141.5	16	2109.2	9	23.5	612	-2.6	NM	2.1	0.3	-8.3	NM	-0.80
ENY TECHNOLOGIES ATI	491.2	-11	984.3	-10	-7.5	NM	-18.6	NM	NM	1.1	-6.2	NM	-0.70
HEM STEEL 8HMSQ	933.5	2	1737.3	-3	-118.9	NM	-216.2	NM	NM	NM	NM	NM	-7.32
RCIAL METALS CMC ⁽⁴⁾	642.9	3	1209.3	1	16.4	53	23.0	86	2.6	1.7	9.3	11	1.68
AR STEEL ROCK	171.5	5	316.2	1	8.0	76	12.0	63	4.6	2.8	6.1	16	1.21
AR TECHNOLOGIES LSS	150.1	-19	273.3	-25	-2.4	NM	-8.3	NM	NM	8.8	-6.8	NM	-0.83
NUE	1141.7	6	2169.8	3	59.7	79	80.0	21	5.2	3.1	5.7	34	1.62
I STEEL MILLS OS	231.3	13	430.4	12	5.2	NM	5.1	NM	2.2	NM	3.0	18	0.35
INDUSTRIES ROU	289.4	15	538.2	12	-8.7	NM	-50.2	NM	NM	3.4	-92.0	NM	-4.97
YNAMICS STLD	213.7	36	380.6	22	17.7	808	21.4	238	8.3	1.2	3.9	43	0.38
NDUSTRIES TXI ⁽⁷⁾	344.4**	4	647.9	10	23.6	999	29.7	NM	6.8	0.6	6.9	10	2.38
STATES STEEL X	1761.0	2	3192.0	-2	27.0	NM	-56.0	NM	1.5	NM	-10.4	NM	-2.81
INGTON INDUSTRIES WOR ⁽⁷⁾	519.3	11	925.0	5	26.8	85	-19.1	NM	5.2	3.1	1.1	NM	0.08
OTHER METALS													
COMPOSITE	9369.1	-14	18279.5	-16	292.0	-18	559.3	-38	3.1	3.3	2.9	63	0.35
	5245.0	-12	10228.0	-16	232.0	-24	416.0	-41	4.4	5.1	5.7	34	0.71
Y ALUMINUM CENX	180.3	-5	359.4	20	-4.6	NM	-8.1	NM	NM	0.7	-15.7	NM	-1.37
NWEALTH INDUSTRIES CMIN	251.7	7	473.6	2	1.1	NM	-3.3	NM	0.4	NM	NM	NM	-11.38
ARD EC	982.3	-33	1984.1	-36	60.1	1	112.4	5	6.1	4.0	21.0	14	1.75
RT-McMORAN COPPER & GOLD FCX	408.0	-24	800.7	-19	15.0	-67	23.1	-75	3.7	8.4	4.7	NM	0.05
AL CABLE 8GC	393.7	-12	755.1	-16	-11.8	NM	-6.9	NM	NM	4.0	-2.0	NM	-0.07
ET INMT	218.0	-4	424.1	-6	5.4	87	9.7	165	2.5	1.3	-1.2	NM	-0.10
R INDUSTRIES MLI	277.2**	-3	545.3	-3	18.5	-11	36.4	0	6.7	7.3	9.3	14	1.80
DODGE PD	966.8	-9	1885.3	-13	-36.4	NM	-41.2	NM	NM	NM	-6.9	NM	-2.82
K NX ⁽²⁾	249.5	13	453.7	8	10.6	148	16.1	102	4.3	1.9	11.7	13	2.54
AR TG	196.5	0	370.2	-4	2.1	-84	5.0	-69	1.1	6.7	-0.6	NM	-0.08
NONBANK FINANCIAL													
TRY COMPOSITE	152459.6	-5	301154.1	-6	17578.2	11	36430.1	16	11.5	9.9	14.9	15	2.45
FINANCIAL SERVICES													
P COMPOSITE	106123.1	-9	209600.5	-11	12764.8	12	26110.4	15	12.0	9.8	17.7	13	2.64
CAN EXPRESS AXP	5945.0	13	11704.0	7	683.0	284	1301.0	82	11.5	3.4	15.2	21	1.41
TEARNS 8SC ⁽¹⁾	2070.4	-15	3788.5	-17	342.9	102	523.4	56	16.6	6.9	14.8	9	5.91
OCK BLK	156.7	16	302.8	13	34.8	33	66.2	28	22.2	19.4	21.7	22	1.86
(H&R) HRB ⁽⁸⁾	1881.3	12	2609.4	12	463.6	24	493.2	30	24.6	22.2	31.7	19	2.31
L ONE FINANCIAL COF	2369.4	37	4502.9	32	213.1	37	401.1	34	9.0	9.0	18.5	10	3.30
UP C	26928.0	-3	52822.0	-8	4084.0	12	8974.0	24	15.2	13.1	19.4	10	3.06
EYWIDE CREDIT INDUSTRIES CCR	1819.4	21	3652.6	38	190.9	55	358.4	58	10.5	8.2	NA	9	4.84
ORD CRD.A	185.8	-5	364.4	-5	4.9	-45	13.0	-23	2.6	4.5	13.5	12	0.53
BRADSTREET DNB	305.2	-5	623.7	-8	10.2	-72	45.8	-32	3.3	11.4	NM	19	1.65
IE GROUP ET	465.0	-11	955.5	-11	33.7	NM	53.0	NM	7.2	NM	-13.2	NM	-0.61

CORPORATE SCOREBOARD

COMPANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE-EARNINGS RATIO 7-25
	2ND QUARTER 2002 \$ MIL	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %		
EDWARDS (A.G.) AGE ⁽¹⁰⁾	600.1	-3	1182.1	-7	39.1	-14	2.1	-98	6.5	7.3	4.0	40
EQUIFAX EFX	270.3	-7	531.7	-7	47.4	24	89.2	23	17.5	13.2	48.5	21
FANNIE MAE FNM	13211.3	5	26198.9	5	1463.7	4	2672.3	6	11.1	11.1	32.1	12
FEDERATED INVESTORS FII	182.4	2	364.0	5	52.6	23	104.9	24	28.8	24.0	65.2	17
FIDELITY NATIONAL FINANCIAL FNF	1143.0	19	2209.8	27	112.3	25	213.3	58	9.8	9.3	22.3	7
FIRST AMERICAN FAF	1092.4	18	2135.4	26	40.1	-26	84.2	15	3.7	5.9	15.0	8
FRANKLIN RESOURCES BEN ⁽³⁾	666.1	9	1292.0	9	125.7	5	245.7	-2	18.9	19.6	10.6	18
FREDDIE MAC FRE	9268.0	-6	19067.0	10	1110.0	21	2523.0	45	12.0	9.3	37.3	8
GALLAGHER (ARTHUR J.) AJG	265.2	24	514.4	19	34.5	49	68.1	36	13.0	10.8	35.4	16
GOLDMAN SACHS GROUP GS ⁽¹⁾	6234.0	-24	11934.0	-32	563.0	-2	1087.0	-19	9.0	7.1	10.9	18
HOUSEHOLD INTERNATIONAL HI	3656.4	10	7366.8	9	513.5	17	1024.5	18	14.0	13.2	23.0	9
INSTINET GROUP INET	268.7**	-32	537.8	-35	-43.3	NM	-53.4	NM	NM	12.0	-0.4	NM
JEFFERIES GROUP JEF	200.9	-7	396.2	-7	18.1	9	35.8	11	9.0	7.7	11.0	17
LEGG MASON LM ⁽⁹⁾	417.4	10	838.2	10	49.0	39	95.1	31	11.7	9.3	15.4	16
LEHMAN BROTHERS HOLDINGS LEH ⁽¹⁾	4347.0	-31	8573.0	-34	296.0	-31	594.0	-27	6.8	6.8	11.7	14
MARSH & MCLENNAN MMC	2612.0	3	5247.0	1	336.0	15	754.0	14	12.9	11.5	20.0	23
MERRILL LYNCH MER	7352.0	-29	14915.0	-33	634.0	17	1281.0	-9	8.6	5.2	2.0	NM
METRIS MXT	268.5	-40	749.7	-12	-36.4	NM	16.0	-87	NM	14.0	17.0	1
MIDDY'S MCO	271.5	32	503.1	31	78.7	42	151.3	46	29.0	27.0	NM	30
MORGAN STANLEY MWD ⁽¹⁾	8149.0	-35	16689.0	-34	797.0	-14	1645.0	-18	9.8	7.4	15.5	13
PRICE (T. ROWE) GROUP TROW	236.1**	-10	478.3	-12	51.9	1	104.9	4	22.0	19.5	18.3	16
RAYMOND JAMES FINANCIAL RJF ⁽³⁾	388.1	-9	769.1	-11	22.8	-21	41.6	-19	5.9	6.8	8.7	17
SCHWAB (CHARLES) SCH	1049.0**	-2	2108.0	-7	98.0	NM	180.0	131	9.3	NM	4.2	69
SEI INVESTMENTS SEIC	158.9	-6	318.1	-4	35.8	15	69.8	17	22.5	18.5	43.3	20
SLM SLM	879.1	-18	1748.9	-19	126.0	-55	548.3	76	14.3	26.2	34.6	22
STILWELL FINANCIAL SV †	310.4	-25	638.7	-26	73.7	-18	170.9	-15	23.7	22.0	18.3	11
STUDENT LOAN SFU	269.5	-15	538.4	-14	42.2	8	91.8	50	15.7	12.3	23.2	10
WFS FINANCIAL WFSI	229.6	33	430.1	29	22.5	15	40.7	6	9.8	11.3	10.6	12
(B) INSURANCE												
GROUP COMPOSITE	38392.9	8	75656.5	8	3209.7	3	7106.8	16	8.4	8.7	8.3	24
AFLAC AFL	2513.0	7	4884.0	3	212.0	39	395.0	19	8.4	6.5	14.2	20
ALLSTATE ALL	7455.0	3	14753.0	3	344.0	105	770.0	14	4.6	2.3	7.3	19
AMBAC FINANCIAL GROUP ABK	201.5**	13	397.6	16	119.8	11	236.7	15	59.4	60.2	13.8	13
AMERICAN INTERNATIONAL GROUP AIG	14938.3	8	29418.0	9	1801.2	32	3781.5	17	12.1	9.9	11.5	23
AMERICAN NATIONAL INSURANCE ANAT	576.2	-1	1165.8	13	21.0	-49	63.1	-19	3.6	7.1	1.7	45
CINCINNATI FINANCIAL CINF	703.0	9	1390.0	10	35.0	-29	110.0	-10	5.0	7.6	2.8	32
EVEREST RE GROUP RE	554.4	14	1128.3	26	53.4	-7	114.5	7	9.6	11.8	4.9	23
MGIC INVESTMENT MTG	383.8**	13	759.4	15	170.9	6	340.1	7	44.5	47.5	20.3	9
MIDLAND MLAN	155.8	8	308.3	9	5.9	-3	15.2	-3	3.8	4.2	8.8	14
PROGRESSIVE PGR	2256.5**	21	4322.1	19	160.4	55	336.6	77	7.1	5.6	16.5	19
SAFECO SAFC	1798.3	5	3510.9	2	105.2	NM	168.8	NM	5.9	NM	0.6	NM
ST. PAUL SPC	2313.8	7	4631.2	7	-218.2	NM	-75.9	NM	NM	4.4	-27.6	NM
TORCHMARK TMK	700.2	2	1400.1	3	62.7	-38	160.9	-20	9.0	14.7	14.2	11
TRAVELERS PROPERTY CASUALTY TAP.A	3319.8	11	6552.5	8	332.0	-8	676.7	-21	10.0	12.2	9.2	12
UNITRIN UTR	523.4	9	1035.3	9	4.4	-99	13.6	-96	0.8	73.9	1.1	NM
(C) SAVINGS & LOAN												
GROUP COMPOSITE	7943.6	-5	15897.1	-4	1603.7	19	3212.9	31	20.2	16.1	17.0	10
DOWNEY FINANCIAL DSL	157.5	-33	355.3	-23	20.3	-39	57.6	-3	12.9	14.3	15.0	9
GOLDEN STATE BANCORP GS8	803.6	-29	1719.3	-24	85.3	-19	207.8	5	10.6	9.3	15.2	11
GOLDEN WEST FINANCIAL GDW	905.1	-22	1843.3	-21	226.4	8	464.4	21	25.0	17.9	19.3	10
GREENPOINT FINANCIAL GPT	442.0	3	871.0	8	123.0	14	243.0	34	27.8	25.2	26.6	9
HUDSON CITY BANCORP HC8K	197.7	17	387.5	15	48.2	56	91.8	49	24.4	18.3	12.9	20
NEW YORK COMMUNITY BANCORP NYCB	180.3	102	341.2	69	58.1	211	104.5	125	32.2	20.9	13.4	16
ROSLYN BANCORP RSLN	163.6	8	315.4	7	36.7	25	70.3	28	22.5	19.5	23.1	13
WASHINGTON MUTUAL WM	4793.0	1	9484.0	1	984.0	23	1935.0	34	20.5	16.8	16.4	10
WESTCORP WES	300.7	15	580.1	15	21.7	29	38.6	11	7.2	6.4	9.9	13
18 OFFICE EQUIPMENT & COMPUTERS												
INDUSTRY COMPOSITE	99131.6	-3	196894.5	-6	5944.3	NM	12978.3	207	6.0	NM	8.3	45
(A) BUSINESS MACHINES & SERVICES												
GROUP COMPOSITE	9356.1	-13	18780.9	-15	315.2	-21	534.0	-30	3.4	3.7	12.8	24
DELUXE DLX	328.5	3	657.4	3	54.7	23	109.3	26	16.7	13.9	380.9	12
DIEBOLD DBD	483.5	14	884.5	10	39.8	43	66.3	88	8.2	6.6	10.5	24
GENERAL BINDING G8ND	174.3	-4	346.6	-7	2.1	NM	-3.8	NM	1.2	NM	-38.3	NM
HDS INDUSTRIES HNI	399.3	10	798.4	-12	20.1	377	36.0	60	5.0	1.0	14.2	18
MILLER (HERMAN) MLHR ⁽⁷⁾	322.6	-37	663.3	-38	-18.8	NM	-30.4	NM	NM	6.4	-21.3	NM
NCR NCR	1380.0	-8	2627.0	-9	32.0	-9	36.0	-77	2.3	2.3	5.8	26
PITNEY BOWES PBI	1081.3	6	2130.8	7	143.1	-24	272.6	-7	13.2	18.4	54.3	18
STANDARD REGISTER SR	253.8	19	517.6	-18	10.9	472	21.9	NM	4.3	0.6	7.4	20
STEELCASE SCS ⁽¹⁰⁾	643.1	-29	1303.5	-31	-15.4	NM	-49.7	NM	NM	2.6	-2.8	NM

ORATE SCOREBOARD

ANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE-EARNINGS RATIO 7-25	12 MONTHS' EARNINGS PER SHARE
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %			
TA TECO ⁽¹¹⁾	3920.4	-16	8085.4	-19	35.1	11	71.6	15	0.9	0.7	8.3	17	2.01
E COMPUTER SERVICES WCS ⁽⁵⁾	369.2	-11	766.3	-11	11.5	-17	4.2	-87	3.1	3.3	5.0	33	0.52
MPUTERS & PERIPHERALS													
COMPOSITE	54255.9	-8	107346.6	-10	1227.5	-36	3250.8	-36	2.3	3.3	7.0	52	0.33
OMPUTER AAPL ⁽³⁾	1429.0	-3	2924.0	1	32.0	-48	72.0	-31	2.2	4.1	4.3	29	0.49
MPUTER DELL ⁽¹¹⁾	8066.0	0	16127.0	-3	457.0	-1	913.0	2	5.7	5.8	27.5	49	0.46
C	1387.5	-31	2689.5	-38	0.8	-99	-76.1	NM	0.1	5.4	-14.7	NM	-0.49
Y GTW	1004.9	-33	1997.2	-43	-58.5	NM	-181.7	NM	NM	NM	-56.7	NM	-2.17
T-PACKARD HPQ ⁽²⁾	10621.0	-9	22004.0	-9	238.0	580	716.0	68	2.2	0.3	6.1	25	0.47
S NFS	165.0	-11	322.0	-17	1.1	-86	-6.7	NM	0.7	4.2	-0.4	NM	-0.04
ATIONAL BUSINESS MACHINES IBM	19651.0	-6	37681.0	-8	445.0	-79	1729.0	-55	2.3	10.0	26.0	22	3.21
K INTERNATIONAL LXX	1058.0	8	2108.1	7	89.1	2	160.6	-4	8.4	8.9	26.9	24	2.00
R MXO	895.8	-14	1940.5	16	-109.0	NM	-174.0	NM	NM	NM	-67.8	NM	-2.04
K APPLIANCE NTAP ⁽⁸⁾	204.9	-9	403.2	-22	7.8	NM	14.8	-57	3.8	0.2	0.4	NM	0.01
ALM ⁽⁷⁾	233.3	41	525.9	-17	-27.5	NM	-24.5	NM	NM	NM	-11.9	NM	-0.14
E TECHNOLOGY STK	491.9	-4	947.8	-3	19.1	56	25.1	171	3.9	2.4	7.9	16	0.79
CROSYSTEMS SUNW ⁽⁶⁾	3420.0	-14	6527.0	-19	20.0	NM	-17.0	NM	0.6	NM	-6.4	NM	-0.19
. TECHNOLOGIES SBL	315.8	-7	617.1	-22	-22.7	NM	-21.5	NM	NM	NM	-3.9	NM	-0.19
UIS	1359.8	-7	2722.3	-12	42.2	44	74.9	-24	3.1	2.0	-3.4	NM	-0.23
RX	3952.0	-8	7810.0	-9	93.0	NM	47.0	-63	2.4	NM	1.7	NM	-0.21
MPUTER SOFTWARE & SERVICES													
COMPOSITE	35519.6	9	70767.0	5	4401.6	NM	9193.5	NM	12.4	NM	8.7	44	0.44
ION ATVI ⁽⁹⁾	191.3	73	356.2	50	20.7	NM	31.6	NM	10.8	0.0	9.8	22	1.18
ACKM ⁽⁹⁾	225.4	10	450.7	0	10.5	NM	25.1	NM	4.6	NM	8.2	30	0.49
SYSTEMS ADBE ⁽¹¹⁾	317.4	-8	585.3	-13	54.3	-11	104.1	-21	17.1	17.8	22.1	33	0.72
CE DATA SYSTEMS AOS	205.5	12	415.9	14	3.9	550	8.4	NM	1.9	0.3	0.6	NM	0.04
AN MANAGEMENT SYSTEMS AMSY	251.7	-21	503.1	-22	1.1	-76	11.9	18	0.4	1.4	4.4	30	0.42
SK AOSK ⁽¹¹⁾	229.3	-7	483.4	-1	17.6	-37	39.4	-30	7.7	11.4	13.3	16	0.70
ATIC DATA PROCESSING AOP ⁽⁶⁾	1845.3**	NA	3715.4	NA	287.3	NA	639.6	NA	15.6	NA	22.0	20	1.75
STEMS BEAS ⁽¹¹⁾	224.8	-13	456.2	-11	3.9	-81	14.5	-63	1.7	8.0	-7.6	NM	-0.13
BOX BBOX ⁽⁹⁾	154.4	-25	314.7	-27	14.7	-3	27.6	-14	9.5	7.3	12.2	13	2.96
E DESIGN SYSTEMS CDN	344.8	-1	689.5	0	-46.3	NM	-25.0	NM	NM	NM	9.7	20	0.55
N CEN	287.8	-1	589.6	-2	24.5	NM	43.1	607	8.5	NM	7.5	23	0.57
CERN	180.6	39	355.9	42	14.7	NM	25.1	NM	8.1	NM	11.1	34	1.22
YSTEMS CSCO ⁽⁵⁾	4822.0	2	9638.0	-16	729.0	NM	1389.0	NM	15.1	NM	4.0	77	0.15
MG ⁽⁵⁾	187.4	-35	398.2	-36	-125.2	NM	-243.1	NM	NM	NM	NM	NM	-4.78
TER ASSOCIATES INTL. CA ⁽⁹⁾	765.0	7	1537.0	7	-65.0	NM	-303.0	NM	NM	NM	-17.8	NM	-1.42
WARE CPWR ⁽⁹⁾	346.6	-23	753.8	-22	22.5	-35	313.4	NM	6.5	7.6	-21.1	NM	-0.69
JAY	266.3	47	511.4	53	54.3	121	101.9	123	20.4	13.6	8.6	NM	0.52
DS (J.D.) JOEC ⁽²⁾	223.6	1	428.3	-4	3.5	NM	-0.6	NM	1.6	NM	-43.1	NM	-1.50
ONIC DATA SYSTEMS EOS	5475.0	8	10816.0	7	316.0	5	670.0	-13	5.8	5.9	17.6	13	2.62
ATA FOC	1875.0**	9	3602.3	8	298.6	22	542.9	25	15.9	14.3	26.2	27	1.26
FISV	632.4	16	1264.4	18	66.6	28	131.8	28	10.5	9.6	13.5	26	1.21
TOP GME ⁽¹¹⁾	271.4	35	785.6	49	4.9	NM	23.7	NM	1.8	NM	3.8	40	0.42
HOLDINGS GTK ⁽¹⁰⁾	231.4	-2	506.0	5	29.0	52	47.5	5	12.5	8.1	40.8	14	1.44
SI	201.0	33	377.7	26	0.8	NM	1.3	NM	0.4	NM	12.7	9	0.90
IMN	274.3	-3	558.0	-4	21.5	117	38.3	159	7.8	3.5	3.1	46	0.62
INTU ⁽⁵⁾	545.2	28	1092.5	24	144.5	NM	264.3	NM	26.5	NM	4.8	86	0.49
KEA	226.1	15	447.3	10	5.5	-18	11.1	-27	2.4	3.4	2.5	43	0.18
SOFT MSFT ⁽⁶⁾	7253.0	10	14498.0	12	1525.0	NM	4263.0	69	21.0	1.0	15.0	30	1.41
RK ASSOCIATES NET	233.0	21	453.7	30	21.2	NM	37.0	NM	9.1	NM	3.4	88	0.12
NOVL ⁽²⁾	273.9	14	551.7	14	-29.7	NM	-21.4	NM	NM	NM	-12.1	NM	-0.38
ORCL ⁽⁷⁾	2773.8	-16	5073.2	-16	655.9	-23	1163.9	-19	23.6	26.0	36.4	23	0.39
ETRIC TECHNOLOGY PMTC ⁽³⁾	182.5	-21	367.5	-23	-24.6	NM	-39.9	NM	NM	NM	-18.8	NM	-0.26
SOFT PSFT	482.2	-11	965.5	-9	36.0	-24	80.6	-3	7.5	8.7	10.5	27	0.59
AL SOFTWARE RATL ⁽⁹⁾	152.5	-13	332.6	-20	-6.5	NM	-18.1	NM	NM	NM	-8.7	NM	-0.29
HOLDINGS TSG	532.7	-8	1072.1	-7	68.0	NM	155.4	NM	12.8	0.9	9.0	32	0.71
SYSTEMS SEBL	405.6	-28	883.4	-24	29.8	-61	94.4	-38	7.3	13.7	9.6	23	0.38
RD DATA SYSTEMS SDS	623.3	31	1231.6	33	81.7	27	151.7	28	13.1	13.5	14.0	21	0.96
SY	205.3	-13	416.3	-10	20.2	NM	36.2	NM	9.8	NM	5.8	29	0.36
TEC SYMC ⁽⁹⁾	316.0	39	626.8	31	56.6	NM	61.3	NM	17.9	NM	3.4	NM	0.31
SYS SNPS ⁽²⁾	185.6	14	361.2	13	21.4	71	35.4	61	11.5	7.6	11.5	37	1.10
HO INTERACTIVE SOFTWARE TTWO ⁽²⁾	170.3	93	453.3	84	9.6	NM	44.5	NM	5.7	NM	17.1	17	1.06
OMS ⁽⁷⁾	338.5	-28	694.5	-37	-23.8	NM	-259.9	NM	NM	NM	-30.6	NM	-1.71
S SOFTWARE VRTS	364.7	-7	735.1	-5	26.0	NM	70.5	NM	7.1	NM	-10.3	NM	-0.74
YHOOD	225.8	24	418.5	15	21.4	NM	31.9	NM	9.5	NM	0.0	NM	-0.01

CORPORATE SCOREBOARD

COMPANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE-EARNINGS RATIO 7-25
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %		
19 PAPER & FOREST PRODUCTS												
INDUSTRY COMPOSITE	21099.9	2	40253.2	-1	476.5	NM	724.2	NM	2.3	NM	-0.8	NM
(A) FOREST PRODUCTS												
GROUP COMPOSITE	7720.0	-3	14813.2	-4	180.6	99	313.4	NM	2.3	1.1	1.8	92
GEORGIA-PACIFIC GP	6222.0	-6	12018.0	-7	87.0	200	148.0	NM	1.4	0.4	-4.5	NM
LOUISIANA-PACIFIC LPX	452.8	-2	864.6	1	7.7	NM	8.5	NM	1.7	NM	-6.4	NM
PLUM CREEK TIMBER PCL	271.0	171	546.0	152	53.0	96	109.0	70	19.6	27.0	16.5	12
RAYONIER RYN	269.3	-20	538.0	-11	17.5	-44	26.5	-39	6.5	9.4	5.7	32
UNIVERSAL FOREST PRODUCTS UFPI	504.9	4	846.6	10	15.4	8	21.4	12	3.0	2.9	14.1	10
(B) PAPER												
GROUP COMPOSITE	13379.8	6	25440.0	1	295.9	NM	410.7	NM	2.2	NM	-2.0	NM
BOISE CASCADE BCC	1888.0	0	3676.3	-3	3.2	-84	-3.4	NM	0.2	1.0	-3.0	NM
INTERNATIONAL PAPER IP	6305.0	-6	12343.0	-9	215.0	NM	280.0	NM	3.4	NM	-5.4	NM
WAUSAU-MDSINEE PAPER WMO	237.8	-1	463.7	-2	5.7	735	9.1	NM	2.4	0.3	5.8	23
WEYERHAEUSER WY	4949.0	29	8957.0	21	72.0	-58	125.0	-55	1.5	4.5	3.0	61
20 PUBLISHING & BROADCASTING												
INDUSTRY COMPOSITE	17114.0	2	32555.5	0	1790.4	420	2959.8	315	10.5	2.1	3.2	51
(A) BROADCASTING												
GROUP COMPOSITE	8222.4	2	15784.8	1	773.0	NM	1213.5	NM	9.4	NM	0.4	NM
CLEAR CHANNEL COMMUNICATIONS CCU	2172.9	0	3870.9	2	238.0	NM	328.4	NM	11.0	NM	-2.0	NM
INSIGHT COMMUNICATIONS ICCI	200.0	10	392.2	10	-11.6	NM	-28.8	NM	NM	NM	-14.6	NM
VIACOM VIA.B	5849.5	2	11521.7	0	546.5	NM	913.9	NM	9.3	0.3	1.1	92
(B) PUBLISHING												
GROUP COMPOSITE	8891.5	2	16770.7	0	1017.4	72	1746.3	37	11.4	6.8	11.7	28
BELT BLC	366.2	1	686.1	-1	40.5	NM	57.3	NM	11.1	NM	3.9	41
DOW JONES DJ	417.0	-14	809.9	-14	54.0	25	183.8	272	12.9	8.9	183.6	14
GANNETT GCI	1624.3	0	3148.9	-2	303.9	30	547.5	34	18.7	14.3	16.4	20
KNIGHT-RIDDER KRI	715.1	-3	1393.3	-5	76.8	472	128.6	137	10.7	1.8	16.4	19
LEE ENTERPRISES LEE (3)	160.8	48	259.1	24	30.8	95	43.9	52	19.2	14.6	9.8	19
McCLATCHY MNI	274.3	-1	526.9	-2	36.2	193	59.5	160	13.2	4.5	9.3	27
McGRAW-HILL MHP	1191.4	4	2038.1	2	136.5	14	165.7	18	11.5	10.4	21.7	28
MEDIA GENERAL MEG	211.8	3	406.3	0	16.3	111	22.3	102	7.7	3.7	2.8	39
NEW YORK TIMES NYT	772.2	2	1509.3	-2	78.8	225	133.2	58	10.2	3.2	21.4	27
SCHOLASTIC SCHL (7)	541.0	8	973.7	4	52.8	NM	64.7	NM	9.8	NM	14.9	15
SCRIPPS (E.W.) SSP	399.9	7	759.7	3	27.0	-31	66.8	-37	6.7	10.6	7.1	61
TRIBUNE TRB	1380.6	1	2614.2	-2	114.2	57	178.2	24	8.3	5.3	2.3	NM
WASHINGTON POST WPO	647.7	7	1248.0	5	51.1	253	74.9	-65	7.9	2.4	5.4	62
WILEY (JOHN) & SONS JW.A (8)	189.2	40	397.2	33	-1.5	NM	19.9	-22	NM	6.1	20.7	23
21 SERVICE INDUSTRIES												
INDUSTRY COMPOSITE	41312.0	5	78725.1	2	1553.7	58	2738.3	7	3.8	2.5	8.5	29
(A) CONSTRUCTION & ENGINEERING												
GROUP COMPOSITE	3075.1	8	5891.4	5	75.5	34	133.2	14	2.5	2.0	12.3	13
DYCDM INDUSTRIES DY (5)	169.8	-16	308.0	-22	7.7	-41	12.7	-51	4.5	6.5	7.1	12
EMCOR GROUP EME	986.4	13	1796.7	5	14.8	28	22.1	28	1.5	1.3	12.7	14
JACOBS ENGINEERING GROUP JEC (3)	1169.1	12	2315.7	13	27.9	24	54.8	24	2.4	2.2	15.3	17
TETRA TECH TTEK (3)	185.4	-3	363.5	-2	8.1	NM	13.4	100	4.4	NM	10.0	11
URS URS (2)	564.4	3	1107.4	4	16.9	31	30.2	35	3.0	2.4	15.6	8
(B) INDUSTRIAL DISTRIBUTION												
GROUP COMPOSITE	8630.4	2	16554.7	-1	257.5	34	481.8	17	3.0	2.3	10.7	22
ADVANCED MARKETING SERVICES MKT (9)	191.9	31	369.7	28	2.4	-23	5.4	-6	1.2	2.1	16.7	10
AG SERVICES OF AMERICA ASV (10)	212.0	29	299.8	32	2.2	18	2.5	2	1.0	1.1	7.8	11
AUDIOVOX VOXX (1)	304.6	10	493.2	-18	4.5	NM	0.3	NM	1.5	NM	-0.7	NM
AVIAL AVL	193.1	44	360.7	36	7.8	118	12.3	96	4.0	2.7	-6.0	NM
BELL MICROPRODUCTS BELM	497.7	9	1020.6	3	-6.1	NM	-5.7	NM	NM	NM	-14.2	NM
CELLSTAR CLST (1)	573.3	0	1202.5	-1	-6.0	NM	-5.5	NM	NM	0.6	-6.3	NM
GENUINE PARTS GPC	2130.9	1	4108.7	-2	96.0	1	183.1	0	4.5	4.5	14.4	17
GRAINGER (W.W.) GWW	1194.8	-2	2320.1	-5	54.5	268	113.0	98	4.6	1.2	14.0	19
MSC INDUSTRIAL DIRECT MSM (4)	208.6	-4	403.4	-8	11.2	352	19.9	18	5.4	1.1	7.4	28
PATTERSON DENTAL PDCO (8)	399.8	31	757.2	27	27.6	31	52.4	27	6.9	6.9	18.5	32
RELIANCE STEEL & ALUMINUM RS	450.2	9	855.7	1	10.8	-6	18.3	-24	2.4	2.8	5.1	26
SCP PDDL POOL	364.1	10	535.4	10	28.6	12	30.5	15	7.9	7.7	23.6	17
UNITED STATIONERS USTR	897.6	-8	1845.7	-9	15.7	-28	39.9	-8	1.8	2.2	9.3	15
WESCO INTERNATIONAL WCC	848.4	-10	1657.4	-11	5.6	-25	10.1	-8	0.7	0.8	12.3	16
WORKFLOW MANAGEMENT WORK (8)	163.4	4	324.6	4	2.7	NM	5.5	NM	1.7	NM	9.8	4
(C) PRINTING & ADVERTISING												
GROUP COMPOSITE	1657.7	-8	3240.7	-10	59.0	40	110.4	26	3.6	2.3	12.8	30
ADVO AD (3)	280.9	0	555.4	0	10.1	-18	18.6	-14	3.6	4.4	221.2	15

ORATE SCOREBOARD

ANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE- EARNINGS RATIO 7-25	12 MONTHS' EARNINGS PER SHARE
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %			
KEY (R.R.) DNY	1148.9	-11	2242.5	-14	24.8	304	47.5	130	2.2	0.5	6.2	55	0.45
ANKS HHS	227.9	0	442.8	-4	24.1	1	44.4	-2	10.6	10.4	15.1	22	0.82
ER SERVICES													
COMPOSITE	27948.7	6	53038.3	4	1161.7	68	2012.8	4	4.2	2.6	7.5	34	0.50
USTRIES ABM ⁽²⁾	476.9**	-3	952.8	-1	14.0	16	22.0	7	2.9	2.5	9.3	24	0.67
TE ACN ⁽⁴⁾	2980.7	1	5894.0	1	114.5	NM	125.1	-45	3.8	NM	-32.9	NA	NA
GROUP APOL ⁽⁴⁾	276.3	29	499.0	32	50.8	44	78.9	52	18.4	16.5	22.7	46	0.78
AUTOMOTIVE GROUP ABG	1154.8	9	2223.0	8	13.8	25	18.9	-2	1.2	1.0	NA	NA	NA
TION AN	5015.6	1	9766.3	-1	103.8	20	195.5	34	2.1	1.7	7.5	14	0.90
EDUCATION CECO	172.0	42	341.9	42	10.3	108	22.3	98	6.0	4.1	14.4	39	1.07
GROUP KMX ⁽¹⁰⁾	1001.6	14	1780.7	17	29.2	10	47.6	39	2.9	3.0	18.1	19	0.86
GENERAL STORES CASY ⁽⁸⁾	464.5*	0	918.7	2	4.4	199	6.6	22	0.9	0.3	8.6	17	0.64
	298.4	-22	611.5	-21	1.4	115	-1.5	NM	0.5	0.2	-7.3	NM	-1.14
T CO	3784.0	63	6400.0	72	266.0	21	581.0	21	7.0	9.5	5.7	26	0.48
Y CEY	255.4	12	490.2	11	22.9	8	39.0	7	9.0	9.3	38.0	24	1.29
AS ⁽⁷⁾	603.8	7	1149.3	5	64.1	7	119.7	4	10.6	10.7	16.5	31	1.36
GYS CVG	572.7	0	1160.2	0	59.1	116	118.7	49	10.3	4.8	14.0	14	1.04
R IT.B ⁽³⁾	236.2	-6	437.3	-8	18.3	NM	13.9	NM	7.7	NM	NM	32	0.24
HR	831.9	6	1618.7	5	1.1	927	2.1	934	0.1	0.0	-23.6	NM	-0.67
I AUTOMOTIVE GPI	1033.1	3	1979.2	2	19.1	36	34.6	48	1.9	1.4	16.1	9	2.86
MAN HDL ⁽⁸⁾	331.3	5	721.2	9	12.1	23	19.3	-26	3.7	3.1	12.8	8	1.39
ALTH RX	353.0	6	684.4	3	62.0	-4	121.2	-7	17.6	19.3	76.2	31	0.45
ERVICES KELYA	1077.0	1	2077.0	-4	3.9	-39	4.7	-58	0.4	0.6	1.6	84	0.28
READY LRW	219.1	-9	389.2	-12	3.5	20	-0.1	NM	1.6	1.2	7.5	29	0.23
WER MAN	2602.9	-1	4886.9	-7	25.7	-26	32.6	-47	1.0	1.3	10.8	29	1.24
MAX HZO ⁽³⁾	170.6	3	304.4	-1	7.7	-6	11.1	-3	4.5	5.0	11.2	12	1.00
UP MPS	288.7	-30	585.1	-31	4.2	17	6.1	-39	1.4	0.9	0.6	NM	0.04
X PAYX ⁽⁷⁾	536.4**	18	1061.4	15	68.7	1	135.6	1	12.8	14.9	29.7	32	0.73
ACEUTICAL PRODUCT DEV. PPDI	151.6	39	282.1	27	17.2	64	1.6	-93	11.4	9.6	6.4	42	0.49
ES TRANSNATIONAL QTRN	384.0	-5	777.3	-4	20.6	113	37.9	117	5.4	2.4	-10.5	NM	-1.31
HALF INTERNATIONAL RHI	473.1	-27	941.6	-31	3.2	-92	12.3	-86	0.7	5.8	5.9	69	0.27
IROL	185.0	2	338.8	2	11.7	29	16.6	50	6.3	5.0	22.5	26	0.74
ENTERPRISES RUSHB	193.1	-3	374.8	-7	2.0	36	2.4	50	1.0	0.7	4.9	8	0.56
IT ENTERPRISES STEI ⁽²⁾	151.0	-12	304.6	-12	12.9	-22	25.6	-24	8.5	9.7	-20.7	NM	-1.49
SYSTEM SERVICES TSS	177.1	10	343.9	9	29.3	13	56.2	17	16.6	16.1	21.0	29	0.56
RENTALS URI	744.8	-3	1343.7	-3	51.1	105	58.7	107	6.9	3.2	10.9	9	1.58
FORMATION SCIENCES VOL ⁽²⁾	367.4	-29	706.2	-31	-3.1	NM	-9.9	NM	NM	0.6	-2.1	NM	-0.31
STC	195.1	1	405.6	2	20.3	4	42.9	4	10.4	10.1	14.9	16	1.14
ARINE WMAR	190.0	1	287.2	3	15.8	16	13.4	28	8.3	7.3	7.8	12	0.85
TELECOMMUNICATIONS													
RY COMPOSITE	50751.4	-9	100370.9	-9	-20491.5	NM	-19133.2	NM	NM	NM	-24.2	NM	-1.72
EQUIPMENT & SERVICES													
COMPOSITE	33575.9	-10	66602.0	-11	-22611.2	NM	-24302.0	NM	NM	NM	-45.3	NM	-2.87
TECOMMUNICATIONS AOCT ⁽²⁾	298.3	-54	591.8	-60	-89.2	NM	-134.0	NM	NM	NM	-21.2	NM	-0.46
†	12104.0	-9	24088.0	-10	-12749.0	NM	-12909.0	NM	NM	NM	-38.8	NM	-4.67
IRELESS SERVICES AWE	3910.0	16	7521.0	14	-3.0	NM	-25.0	NM	NM	10.2	-0.7	NM	-0.09
ANIAL COMMUNICATIONS CYCL ⁽⁷⁾	191.6	17	368.3	15	-18.8	NM	-31.8	NM	NM	NM	NM	NM	-0.64
YTEL CTL	380.5	3	753.2	2	40.2	91	83.1	73	10.6	5.7	9.4	9	2.66
RSE TECHNOLOGY CMVT ⁽¹¹⁾	211.2	-42	476.3	-33	-23.6	NM	-77.6	NM	NM	21.6	-3.0	NM	-0.26
G GLW	896.0**	-52	1794.0	-53	-370.0	NM	-460.0	NM	NM	NM	-26.3	NM	-1.42
⁽⁵⁾	401.7	20	775.7	24	-49.6	NM	-66.8	NM	NM	NM	-26.9	NM	-3.50
IRELESS INTERNATIONAL LWIN	151.1	216	291.3	244	-158.6	NM	-355.2	NM	NM	NM	NM	NM	-16.14
COMMUNICATIONS LVLTL	750.0	94	1136.0	36	-232.0	NM	-452.0	NM	NM	NM	NM	NM	-12.19
TECHNOLOGIES LU ⁽³⁾	2949.0	-50	6465.0	-45	-7837.0	NM	-8432.0	NM	NM	NM	NM	NM	-4.79
COMMUNICATIONS NXTL	2154.0	25	4111.0	24	123.0	NM	-468.0	NM	5.7	NM	NM	NM	-3.52
SAT SPOT	209.2	0	416.4	1	19.8	576	43.3	446	9.4	1.4	2.2	50	0.44
FIC-ATLANTA SFA ⁽⁶⁾	390.1	-37	842.8	-34	-15.6	NM	28.1	-81	NM	11.8	7.3	18	0.66
FON GROUP FON	3965.0	-8	7994.0	-8	102.0	-65	388.0	-36	2.6	6.7	-3.0	NM	-0.40
PCS GROUP PCS	3018.0	32	5866.0	36	-170.0	NM	-316.0	NM	NM	NM	NM	NM	-0.93
ONE & DATA SYSTEMS TDS	723.8	13	1389.0	12	-947.9	NM	-934.3	NM	NM	NM	-27.4	NM	-13.59
S TLAB	344.6	-32	716.1	-44	-142.8	NM	-137.5	NM	NM	NM	-11.0	NM	-0.65
LLULAR USM	527.7	11	1006.1	10	-89.1	NM	-45.2	NM	NM	12.1	1.8	51	0.47
TELEPHONE COMPANIES													
COMPOSITE	17175.5	-5	33768.9	-5	2119.7	-27	5168.8	-9	12.3	16.2	17.2	15	1.62
UTH BLS	5780.0	-3	11314.0	-5	293.0	-67	1448.0	-18	5.1	14.7	12.7	19	1.19
WING BRW	552.5	-6	1089.9	-5	-18.3	NM	165.8	NM	NM	NM	-17.4	NM	-1.26
MMUNICATIONS S8C †	10843.0	-6	21365.0	-6	1845.0	-11	3555.0	-10	17.0	18.1	21.7	13	2.04

CORPORATE SCOREBOARD

COMPANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY 12 MONTHS ENDING 6-30	PRICE EARNINGS RATIO 7-25
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %		
23 TRANSPORTATION												
INDUSTRY COMPOSITE	51157.7	-6	98387.3	-7	407.3	-16	-441.2	NM	0.8	0.9	-5.1	NM
(A) AIRLINES												
GROUP COMPOSITE	21298.4	-15	40347.4	-16	-1387.0	NM	-3572.7	NM	NM	NM	-75.7	NM
AIRTRAN HOLDINGS AAI	190.6	-7	349.9	-8	5.1	-61	2.1	-91	2.7	6.4	-69.0	NM
ALASKA AIR GROUP ALK	574.1	-1	1071.0	-2	-4.5	NM	-38.6	NM	NM	0.7	-6.1	NM
AMERICA WEST HOLDINGS AWA	544.1	-7	1004.4	-14	-8.5	NM	-94.5	NM	NM	NM	-99.0	NM
AMR AMR	4479.0	-20	8615.0	-17	-495.0	NM	-1070.0	NM	NM	NM	-51.9	NM
CONTINENTAL AIRLINES CAL	2192.0	-14	4186.0	-16	-139.0	NM	-305.0	NM	NM	1.6	-38.9	NM
DELTA AIR LINES DAL	3474.0	-8	6577.0	-14	-186.0	NM	-583.0	NM	NM	NM	-50.0	NM
EXPRESSJET HOLDINGS XJT	269.7	4	534.9	6	20.6	63	40.6	59	7.6	4.9	NM	10
NORTHWEST AIRLINES NWAC	2406.0	-11	4586.0	-14	-93.0	NM	-264.0	NM	NM	NM	NM	NM
SOUTHWEST AIRLINES LUV	1472.8	-5	2730.0	-8	102.3	-42	123.7	-58	6.9	11.3	8.0	29
UAL UAL	3793.0	-19	7081.0	-22	-341.0	NM	-850.0	NM	NM	NM	NM	NM
US AIRWAYS GROUP U	1903.0	-24	3612.0	-24	-248.0	NM	-534.0	NM	NM	NM	NM	NM
(B) RAILROADS												
GROUP COMPOSITE	9027.0	1	17619.0	-1	752.0	15	1300.0	23	8.3	7.3	8.6	16
BURLINGTON NORTHERN SANTA FE BNI	2207.0	-3	4370.0	-4	194.0	-1	366.0	9	8.8	8.6	9.6	14
CSX CSX	2073.0	1	4037.0	-1	135.0	25	203.0	59	6.5	5.3	6.0	19
NORFOLK SOUTHERN NSC	1593.0	0	3091.0	-1	119.0	11	205.0	22	7.5	6.7	6.4	19
UNION PACIFIC UNP	3154.0	5	6121.0	3	304.0	25	526.0	24	9.6	8.1	10.6	14
(C) TRANSPORTATION SERVICES												
GROUP COMPOSITE	8855.1	2	16979.6	0	348.9	NM	552.6	430	3.9	NM	6.2	33
CNF CNF	1186.3	-6	2253.3	-11	21.9	NM	42.2	NM	1.8	NM	-26.1	NM
DOLLAR THRIFTY AUTOMOTIVE GROUP DTG	302.5	4	545.2	4	17.5	41	29.7	37	5.8	4.3	4.6	22
FEDEX FDX (7)	5416.0	6	10435.0	5	236.0	109	356.0	61	4.4	2.2	11.1	20
GATX GMT	331.5	-22	634.3	-19	20.4	-9	39.3	46	6.2	5.3	2.2	59
HOTELS.COM ROOM	229.7	66	395.4	62	18.8	305	31.8	389	8.2	3.4	6.7	61
RYDER SYSTEM R	1209.3	-7	2359.2	-8	29.5	48	46.3	93	2.4	1.5	3.2	37
WABTEC WAB	179.8	-7	357.1	-13	4.8	-25	7.4	-49	2.6	3.3	2.8	81
(D) TRUCKING & SHIPPING												
GROUP COMPOSITE	11977.3	2	23441.3	1	693.4	-3	1278.9	-6	5.8	6.1	19.0	28
ALEXANDER & BALDWIN ALEX	279.2	-5	513.0	-10	12.5	-49	17.8	-62	4.5	8.4	12.6	10
ARKANSAS BEST ABFS	345.1	-15	665.3	-18	6.5	-34	7.9	-58	1.9	2.4	9.2	17
HUNT (J.B.) TRANSPORT SERVICES JBHT	557.3	7	1067.5	5	15.5	81	20.3	99	2.8	1.6	9.1	22
LANDSTAR SYSTEM LSTR	391.2	9	726.9	5	12.2	12	20.8	8	3.1	3.1	31.1	18
ROADWAY ROAD	697.1	9	1334.3	3	5.7	41	3.9	-56	0.8	0.6	7.3	21
U.S. XPRESS ENTERPRISES XPRSA	215.6	6	412.9	6	1.2	211	0.3	NM	0.6	0.2	0.0	NM
UNITED PARCEL SERVICE UPS	7682.0	3	15261.0	2	611.0	-3	1174.0	-3	8.0	8.4	23.2	29
USFREIGHTWAYS USFC	626.7	0	1202.5	-3	5.9	-48	-1.7	NM	0.9	1.8	2.7	50
WERNER ENTERPRISES WERN	340.4	5	653.0	4	16.6	37	27.2	26	4.9	3.7	8.7	23
YELLOW YELL	842.5	2	1604.9	-3	6.2	10	8.4	13	0.7	0.7	3.1	39
24 UTILITIES & ENERGY SERVICES												
INDUSTRY COMPOSITE	94790.5	1	182349.0	-10	3178.9	-24	6960.1	-19	3.4	4.5	10.9	13
(A) ELECTRIC, WATER & COGENERATION												
GROUP COMPOSITE	88669.5	1	168676.1	-8	2737.0	-28	5741.2	-21	3.1	4.3	10.7	12
AES AES	2131.0	14	4391.0	11	-98.0	NM	74.0	-72	NM	7.8	9.3	3
ALLETE ALE	371.7	3	728.1	0	33.2	-16	66.6	-5	8.9	10.9	10.1	13
AMEREN AEE	1124.0	6	2239.0	8	138.0	41	200.0	20	12.3	9.3	14.3	11
AMERICAN ELECTRIC POWER AEP	15200.0	8	28300.0	1	23.9	-91	-151.0	NM	0.2	2.0	8.1	30
CH ENERGY GROUP CHG	152.9	-8	350.1	-14	2.0	-50	22.3	-4	1.3	2.4	10.0	14
CINERGY CIN	2480.0	-32	4683.8	-37	45.8	-45	142.4	-30	1.8	2.3	11.9	13
CLECO CNL	370.6	22	590.9	6	17.8	26	31.8	22	4.8	4.6	13.9	8
CONECTIV CIV	1100.2	-35	2136.2	-34	41.5	-84	69.6	-78	3.8	15.5	10.3	15
CONSOLIDATED EDISON ED	1900.2	-10	3999.4	-20	101.0	-3	271.0	-5	5.3	4.9	11.6	12
DOMINION RESOURCES D	2347.0	2	4981.0	-10	272.0	75	593.0	86	11.6	6.7	9.3	18
DUKE ENERGY DUK	16333.0	5	28218.0	-12	474.0	13	856.0	-12	2.9	2.7	12.5	10
FIRSTENERGY FE	2543.7	63	5750.9	52	258.4	59	367.3	28	8.8	9.0	9.7	11
FPL GROUP FPL	2248.0	4	4092.0	0	254.0	14	424.0	26	11.3	10.2	14.9	10
GREAT PLAINS ENERGY GXP	69.7	36	834.3	33	36.0	-1	33.1	-1	7.7	10.5	-5.5	NM
HAWAIIAN ELECTRIC INDUSTRIES HE	409.0	-4	786.4	-9	31.5	18	58.9	7	7.7	6.2	11.8	12
NORTHEAST UTILITIES NU	1073.2	6	3583.9	6	30.2	-38	50.3	-73	1.8	3.1	6.2	15
NSTAR NST	600.4	-18	1323.3	-17	5.7	-85	40.5	NM	0.9	5.2	10.7	15
PINNACLE WEST CAPITAL PNW	714.9	-45	1335.9	-40	75.4	13	129.1	0	10.5	5.2	12.8	8
PNM RESOURCES PNM	264.6	-60	578.6	-59	11.2	-78	36.1	-68	4.2	7.4	7.0	10
PPL PPL	1301.0	-8	2576.0	-13	-12.0	NM	152.0	-58	NM	9.2	-2.7	NM
PROGRESS ENERGY PGN	2038.3	-12	3926.6	-7	120.6	8	253.1	-5	5.9	4.8	8.6	18
PUBLIC SERVICE ENTERPRISE GROUP PEG	2064.0	1	4432.0	-7	-227.0	NM	-47.0	NM	NM	7.4	7.7	21

ORATE SCOREBOARD

ANY SYMBOL	SALES				PROFITS				MARGINS		RETURN ON COMMON EQUITY		PRICE-EARNINGS RATIO	12 MONTHS' EARNINGS PER SHARE
	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 \$ MIL.	CHANGE FROM 2001 %	6 MONTHS 2002 \$ MIL.	CHANGE FROM 2001 %	2ND QUARTER 2002 %	2ND QUARTER 2001 %	12 MONTHS ENOING 6-30	12 MONTHS ENOING 7-25		
ENERGY PSD	555.0	-41	1312.3	-36	31.4	61	57.8	-46	5.7	2.1	4.7	26	0.74	
ENERGY REI	9790.4	-5	18434.2	-18	235.6	-26	461.0	-11	2.4	3.1	12.0	3	2.91	
RESOURCES RRI	8560.9	7	15590.9	-6	178.5	-22	275.3	-10	2.1	2.9	8.3	3	1.76	
RN SO	2632.0	3	4846.0	0	336.0	22	564.7	23	12.8	10.7	15.1	15	1.74	
ENERGY TE	820.0	28	1560.2	19	85.7	19	161.1	14	10.5	11.2	16.4	9	2.31	
J	7205.0	18	15302.0	6	203.0	-4	478.0	15	2.8	3.4	11.3	12	3.32	
DINGS UIL	284.3	8	542.6	8	9.1	-40	18.7	-24	3.2	5.8	10.6	11	3.75	
SOURCES WPS	579.4	0	1250.7	-21	22.5	80	51.4	40	3.9	2.2	12.3	11	3.03	
S, OIL & ENERGY SERVICES														
COMPOSITE	6121.0	-7	13672.9	-28	441.9	8	1218.9	-9	7.2	6.2	12.5	13	1.85	
SOURCES ATG	570.1	224	1063.0	102	12.3	32	62.4	1	2.2	5.3	10.4	15	1.37	
BLE RESOURCES EQT	268.6	-22	612.7	-49	29.2	-7	81.6	-21	10.9	9.1	16.0	16	2.00	
N KSE	1216.1	-9	3087.7	-21	29.2	NM	243.8	14	2.4	NM	8.7	17	1.88	
MORGAN KMI †	213.7	-2	505.1	-7	72.5	45	160.8	51	33.9	22.8	12.8	16	2.39	
SOURCES GROUP MDU	480.2	-12	862.2	-27	24.9	-43	48.6	-36	5.2	7.9	11.3	11	1.84	
RSEY RESOURCES NJR (3)	442.3	70	968.1	-16	4.8	10	39.7	6	1.1	1.7	15.2	13	2.09	
SAS	395.7	6	1012.7	-45	17.1	-36	57.0	-13	4.3	7.2	18.2	8	3.02	
(3)	191.3	-14	469.3	-27	-2.6	NM	14.1	-33	NM	1.2	6.6	11	1.67	
ENERGY OEI	288.0	-19	508.3	-33	48.5	-42	69.0	-67	16.8	23.6	8.9	23	0.78	
NT NATURAL GAS PNY (2)	293.9	-28	582.6	-33	41.8	5	83.0	-8	14.2	9.8	9.3	18	1.79	
A ENERGY SRE	1374.0	-27	2979.0	-41	150.0	7	299.0	-7	10.9	7.4	18.4	8	2.40	
N VVC	387.0	-11	1022.2	-22	14.3	NM	59.9	94	3.7	NM	11.1	15	1.43	

ALPHABETICAL LIST OF COMPANIES

The number following each company name identifies the Scoreboard category under which it is listed

laboratories 12b	American Mgmt. Systems 18c	B	Broadcom 9d	Cisco Systems 18c	D	Express Scripts 12c
bie & Fitch 8	American National 17b	Baker Hughes 11b	Broadwing 22b	Citigroup 17a	Dana 2b	ExpressJet Holdings 23a
stries 21d	American Standard 13a	Ball 7a	Brown Shoe 6a	City National 3d	Danaher 9c	
e 21d	Ameristar Casinos 14b	BancorpSouth 3a	Brown-Forman 6c	CKE Restaurants 14a	Darden Restaurants 14a	F
n 18c	Ames Dept. Stores 8	Brunswick 14d	Brunswick 14d	Claire's Stores 8	Deere 15c	Fairchild Semiconductor 9d
ands 9a	Ametek 9a	Building Materials 8	Bunge 10b	Clarcor 15c	Dell Computer 18b	Family Dollar Stores 8
8c	Amgen 12b	Burlington Northern Santa Fe 23b	Burlington Resources 11a	Clear Channel Communs. 20a	Delphi 2b	Fannie Mae 17a
omm. 22a	Amphenol 9d	Butler Mfg. 15a		Cleco 24a	Delta Air Lines 23a	Fastenal 8
stems 18c	AMR 23a			CMGI 18c	Deluxe 18a	Fedders 6b
d Marketing 21b	AmSouth Bancorporation 3c			CNF 23c	Dentsply Intl. 12d	Federal Signal 15a
d Micro 9d	Anadarko Petroleum 11a			Coca-Cola 6c	Dial 6d	Federated Dept. Stores 8
PCS 12c	Analog Devices 9d			Coca-Cola Bottling 6c	Diamond Offshore 11b	Federated Investors 17a
c	Andrew 9b			Coca-Cola Enterprises 6c	Diebold 18a	FedEx 23c
stries 15a	Anheuser-Busch 6c			Cole National 8	Dillard's 8	Fidelity National Finl. 17a
	Anixter International 5			Colgate-Palmolive 6d	Dole Food 10b	Fifth Third Bancorp 3b
7b	AnnTaylor Stores 8			Colonial BancGroup 3a	Dollar General 8	Finish Line 8
c	AOL Time Warner 14b			Comerica 3b	Dollar Thrifty Automotive 23c	Finlay Enterprises 8
stems 9d	Apache 11a			Commerce Bancorp 3a	Dominion Resources 24a	First American 17a
chnologies 9c	Apogee Enterprises 15a			Commerce Bancshares 3b	Donaldson 15c	First Citizens BancShares 3c
urces 24b	Apollo Group 21d			Commercial Metals 16a	Donnelley (R.R.) 21c	First Data 18c
cts & Chemicals 4	Apple Computer 18b			Commonwealth Inds. 16b	Dover 15c	First Tennessee Natl. 3c
holdings 23a	Applied Biosystems 9c			Community Health Sys. 12c	Dow Chemical 4	First Virginia Banks 3c
Holding 16a	Applied Materials 15c			Computer Associates 18c	Dow Jones 20b	FirstEnergy 24a
r Group 23a	Apria Healthcare Group 12c			Compuware 18c	Downey Financial 17c	FirstMerit 3b
le 4	AptarGroup 15a			ConAgra Foods 10b	Dress Barn 8	Fiserv 18c
Culver 8	Arch Coal 11a			Connect 24a	Dreyer's Grand Ice Cream 10b	FleetBoston Financial 3a
n's 10c	Archer Daniels 10b			Conoco 11a	Duke Energy 24a	Fleetwood Ent's. 14d
b	Argosy Gaming 14b			Consol Energy 11a	Dun & Bradstreet 17a	Flowserve 15c
& Baldwin 23d	Arkansas Best 23d			Consolidated Edison 24a	DuPont 4	FMC 4
y Tech. 16a	ARRIS Group 9b			Constellation Brands 6c	Dura Automotive Systems 2b	Foodarama 10c
12b	ArvinMeritor 2b			Continental Airlines 23a	Dycom Industries 21a	Foot Locker 8
la	Asbury Automotive 21d			Convergys 21d		Footstar 8
Data Sys. 18c	Ashland 11a			Cooper Cameron 11b	E*Trade Group 17a	Ford Motor 2a
17b	Associated Banc-Corp 3a			Cooper Tire & Rubber 2c	Eagle Food Centers 10c	Forest City Ent. 13b
d	AT&T 22a			Coors (Adolph) 6c	Eastman Kodak 14d	Forest Laboratories 12b
com 8	AT&T Wireless 22a			Com Products Intl. 10b	Eaton 2b	Fortune Brands 15a
erty 13b	Atmel 9d			Corning 22a	eBay 18c	FPL Group 24a
financial 17b	Autodesk 18c			Costco Wholesale 8	Ecolab 6d	Franklin Resources 17a
ertainment 14b	Autoliv 2b			Countrywide Credit 17a	Edwards (A.G.) 17a	Freddie Mac 17a
Industrial 2b	Automatic Data 18c			Crane 15c	Edwards (J.D.) 18c	Fred's 8
a Hess 11a	AutoZone 8			Crawford 17a	Edwards Lifesciences 12d	Freepoint-McMoran C&G 16b
24a	AvalonBay Communities 13b			Crompton 4	Electronic Data Systems 18c	Fuller (H.B.) 4
West Holdings 23a	Avaya 9b			Crown Cork & Seal 7a	Electronics Boutique 8	
n Axle & Mfg. 2b	Avery Dennison 15a			CSK Auto 8	EMC 18b	Gallagher (Arthur J.) 17a
n Eagle Outfitters 8	Aviall 21b			CSX 23b	Emcor Group 21a	GameStop 18c
n Electric 24a	Avon Products 6d			Cummins 15c	Engelhard 16b	Gannett 20b
n Express 17a	AVX 9d			Cypress Semiconductor 9d	ENSCO International 11b	Gap 8
n Greetings 14d	Aztar 14b			Circuit City Group 6b	Equifax 17a	Gart Sports 8
n Intl. Group 17b					Equitable Resources 24b	Gartner 21d
					Everest Re Group 17b	Gateway 18b

ALPHABETICAL LIST OF COMPANIES

The number following each company name identifies the Scoreboard category under which it is listed

GATX 23c GenCorp 2b Genentech 12b General Binding 18a General Cable 16b General Dynamics 1 General Electric 5 General Mills 10b General Motors 2a Genesco 8 Genlyte Group 9a Genuine Parts 21b Genzyme General 12b Georgia-Pacific 19a Gevity 21d Gibraltar Steel 16a Gillette 6d Golden State Bancorp 17c Golden West 17c Goldman Sachs Group 17a Good Guys 6b Goodrich 1 Goodyear Tire & Rubber 2c Goody's Family Clothing 8 Gottschalks 8 Grace (W.R.) 4 Grainger (W.W.) 21b Graphic Packaging Intl. 7b Great Lakes Chemical 4 Great Plains Energy 24a GreenPoint Financial 17c Greif Bros. 7b Group 1 Automotive 21d Gtech Holdings 18c GTSI 18c Guidant 12d	Instinet Group 17a Intel 9d Interface 15d Intermet 16b International Flavors 4 International Game Tech. 15a Intl. Multifoods 10a International Paper 19b Interstate Bakeries 10b Intuit 18c Invacare 12d Isle of Capri Casinos 14b ITT Industries 15c	MarineMax 21d Marriott Intl. 14c Marsh & McLennan 17a Marshall & Ilsley 3b Mattel 14d Maxtor 18b May Department Stores 8 Maytag 6b MBNA 3a McClatchy 20b McCormick 10b McDonald's 14a McGraw-Hill 20b McKesson 12a MDU Resources Group 24b MeadWestvaco 7b Media General 20b Medtronic 12d Mellon Financial 3a Men's Wearhouse 8 Mercantile Bankshares 3a Merck 12b Merrill Lynch 17a Metris 17a Metro-Goldwyn-Mayer 14b Mettler-Toledo Intl. 15c MGIC Investment 17b MGM Mirage 14b MI Schottenstein Homes 13b Michaels Stores 8 Microchip Technology 9d Micron Technology 9d Microsoft 18c Midland 17b Miller (Herman) 18a Millipore 9c Minerals Technologies 4 Modine Mfg. 2b Mohawk Industries 15d Molex 9d Monsanto 4 Moody's 17a Morgan Stanley 17a Motorola 9b MPS Group 21d MSC Industrial Direct 21b Mueller Industries 16b Murphy Oil 11a Myers Industries 15a	NSTAR 24a Nu Skin Enterprises 12a Nucor 16a NUI 24b NVIDIA 9d NVR 13b	O Occidental Pet. 11a Ocean Energy 24b Office Depot 8 OfficeMax 8 OMNOVA Solutions 15a ON Semiconductor 9d Oracle 18c Oregon Steel Mills 16a O'Reilly Automotive 8 Owens & Minor 12d Owens-Illinois 7a Oxford Industries 6a	P Paccar 2a Pacific Sunwear of Calif. 8 Packaging Corp. America 7b Pactiv 7b Pall 5 Palm 18b PanAmSat 22a Parametric Technology 18c Pathmark Stores 10c Patterson Dental 21b Paychex 21d Payless ShoeSource 8 PC Connection 8 PC Mall 8 Penn Traffic 10c Penney (J.C.) 8 Pentair 15c PeopleSoft 18c Pep Boys 8 Pepsi Bottling Group 6c PepsiAmericas 5 PepsiCo 6c PerkinElmer 9c Petco Animal Supplies 8 Petsmart 8 Pfizer 12b Pharmaceutical Product Dev. 21d Pharmacia 12b Phelps Dodge 16b Philip Morris 6c Phillips Petroleum 11a Phillips-Van Heusen 6a Piedmont Natural Gas 24b Pier 1 Imports 6b Pilgrim's Pride 10b Pinnacle West 24a Pitney Bowes 18a Plexus 9d Plum Creek Timber 19a PNM Resources 24a Pogo Producing 11a Polaris Industries 14d Popular 3c Potlatch 7b PPG Industries 13a PPL 24a Praxair 4 Price (T. Rowe) 17a PriceSmart 8 Priority Healthcare 12a Progress Energy 24a Progressive 17b Public Service Ent. 24a Puget Energy 24a Pulte Homes 13b	R R.J. Reynolds Tobacco 6e RadioShack 6b Rational Software 18c Raymond James Finl. 17a Rayonier 19a Raytheon 1 Reebok International 6a Regal-Beloit 9a Regions Financial 3c Reliance Steel & Alum. 21b Reliant Energy 24a Reliant Resources 24a Rite Aid 12a Rockway 23d Robert Half International 21d Rock-Tenn 7b Rockwell Automation 9a Rockwell Collins 1 Rollins 21d Roper Industries 15c Roslyn Bancorp 17c Ross Stores 8 Rouge Industries 16a Ruby Tuesday 14a Ruddick 10c Rush Enterprises 21d Ryan's Family Steak 14a Ryder System 23c	S Sabre Holdings 18c SafeCo 17b Safeway 10c Saks 8 Samsonite 15a Sanderson Farms 10b Sanmina-SCI 9d SBC Communications 22b Scherer-Plough 12b Schlumberger 11b Scholastic 20b Schulman (A.) 4 Schwab (Charles) 17a Scientific-Atlanta 22a SCP Pool 21b Scripps (E.W.) 20b Sealed Air 7b Sears, Roebuck 8 SEI Investments 17a Sempra Energy 24b Sensient Tech. 4 7-Eleven 10c Shaw Group 15a Sherrin-Williams 8 Shiloh Industries 15a ShopKo Stores 8 Siebel Systems 18c Sierra Health Services 12c Sigma-Aldrich 12b Skechers U.S.A. 6a Sky Financial Group 3b SLM 17a Smart & Final 10c Smith (A.O.) 9a Smith International 11b Smithfield Foods 10b Smucker (J.M.) 10b Smurfit-Stone Container 7b Snap-on 15b Soletron 9d Sonoco Products 7b Southern 24a SouthTrust 3c Southwest Airlines 23a Spartech 15a Sports Authority 8 Sprint FON Group 22a Sprint PCS Group 22a SPS Technologies 15a SPX 9a St. Jude Medical 12d St. Paul 17b Stage Stores 8 Standard Motor Prods. 2b	Standard Register 18a Stanley Works 15b Staples 8 Starwood Hotels & Resorts 14c State Street 3a Station Casinos 14b Steel Dynamics 16a Steelcase 18a Steris 12d Stewart & Stevenson 15c Stewart Enterprises 21d Stilwell Financial 17a Stoneridge 9d Storage Technology 18b Stride Rite 6a Stryker 12d Student Loan 17a Sun Microsystems 18b SunGard Data Systems 18c Sunoco 11a SunTrust Banks 3c Superior Industries Intl. 2b Supervalu 10a Sybase 18c Symantec 18c Symbol Technologies 18b Synopsys 18c Synovus Financial 3c	T Take-Two Interactive 18c Talbots 8 Target 8 TCF Financial 3b Tech Data 18a Teco Energy 24a Tektronix 9c Tellex 15a Telephone & Data Sys. 22a Tellabs 22a Temple-Inland 7b Tenet Healthcare 12c Tenneco Automotive 2b Teradyne 9c Tetra Tech 21a Texas Industries 16a Texas Instruments 9d Textron 5 Thermo Electron 9c Thomas & Betts 9d Thor Industries 14d 3Com 18c 3M 15a Ticketmaster 14b Tidewater 11b Tiffany 8 Timberland 6a Timken 15c TJX 8 Toll Brothers 13b Toor 8 Torchmark 17b Toro 15c Total System Services 21d Tower Automotive 2b Toys 'R' Us 8 Tractor Supply 8 Trans World Entertainment 14d Travelers Property Casualty 17b Tredegar 16b Tribune 20b Trump Hotels 14b TRW 5 Turnerware 15a TXU 24a Tyco Intl. 5	UnionBanCal 3d Unisys 18b United Natural Food United Parcel Service United Rentals 21d United States Steel United Stationers 21b United Technologies 1 UnitedHealth Group 1 Unitrin 17b Universal Forest Prod. Universal Health 12c Unocal 11a URS 21a US Airways Group 23a USFreightways 23d UST 6e UTStarcom 9b	V Vail Resorts 14b Vallmont Industries 15c Valspar 13a Value City 8 Vectren 24b Veritas Software 18c VF 6a Viacom 20a Village Super Market 1 Visteon 2b Volt Info. Sciences 21b Vulcan Materials 13a	W Wabtec 23c Wachovia 3c Walgreen 12a Wallace Computer 18a Wal-Mart Stores 8 Walter Industries 5 Washington Mutual 17 Washington Post 20b Waters 9c Wausau-Mosinee Paper Weatherford Intl. 11b Weiss Markets 10c WellPoint Health 12c Wells Fargo 3b Wendy's Intl. 14a Werner Enterprises 23b WESCO International 2 West 21d West Marine 21d Westcorp 17c WestPoint Stevens 15d Wet Seal 8 Weyerhaeuser 19b WFS Financial 17a Whirlpool 6b Wickes 8 Wiley (John) & Sons 20b Williams-Sonoma 6b Winnebago Industries 1 Wolverine World Wide Woodward Governor 9a Workflow Mgmt. 21b Worthington Inds. 16a WPS Resources 24a Wrigley (Wm.) Jr. 10b Wyeth 12b	X Xerox 18b Xilinx 9d XTQ Energy 11a	Y Yahoo! 18c Yellow 23d York Intl. 13a YUM! Brands 14a	Z Zale 8 Zimmer Holdings 12d Zions Bancorporation 3a
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State of the Union Address
January 29, 2002



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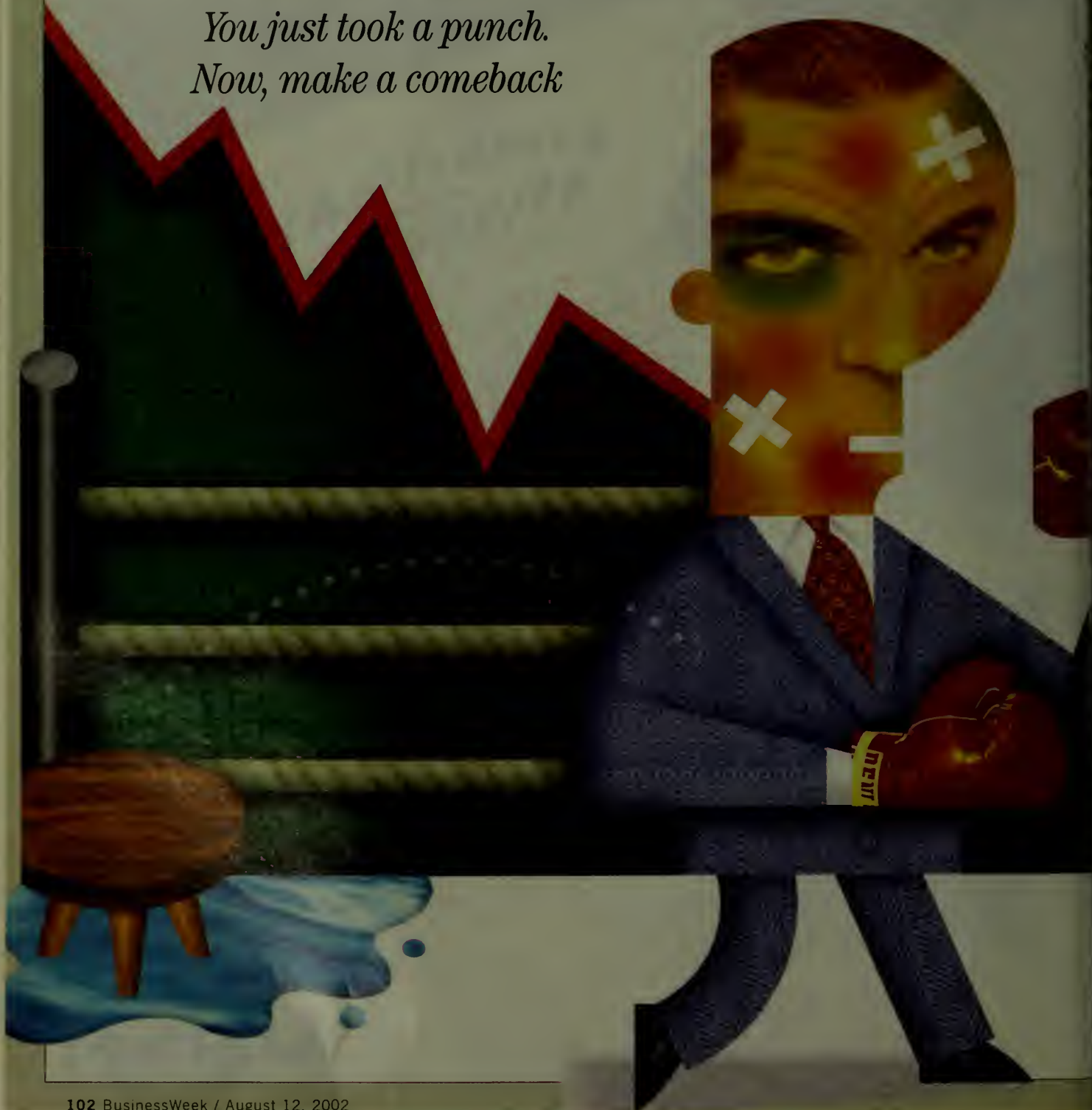
**Coping
With the
Market**

BY SUSAN SCHERREIK

How to Stay On Your Feet

*You just took a punch.
Now, make a comeback*

What we took as articles of faith during the bull market are being reexamined in the light of the worst bear market in decades. Is buying and holding stocks for the long term really the only strategy? Will stocks always beat bonds over the long run? Will diversification—and index funds, the ultimate diversifiers—protect your money from disasters such as Enron?



WorldCom? By and large, the old rules are dead. The problem, in retrospect, was that we treated them as though they were immutable, natural rather than man-made guideposts that lead us down the road to retirement, education for our children, or an inheritance for the grandchildren.

In such a heated environment, stick to the basics of investing. "Decision-making under conditions of uncertainty is a frightening prospect," says Peter L. Bernstein, who heads a New York advisory firm for institutional investors that bears his name. "You stand a better chance of doing well if you have a plan."

It's necessary to scrutinize how you apply the old rules in a much-changed world. Take, for instance, the assumptions about expected returns on stocks. During the bull market, investors and financial advisers used a guideline of 10% annually—and thought themselves prudent for doing so because they were making multiples of that every year. What people haven't always realized is that there can be long stretches when stocks decline or stagnate. The Dow Jones Industrial average, for instance, briefly edged up 1,000 in 1972 and again in 1976, 1980, and 1982. It wasn't until the bull market began in 1982, however, that the Dow sprinted past 1,000, according to Ned Davis Research.

One way to navigate a low-return market is to invest in dividend-paying stocks. A 2% payout a year was laughable a few years back when many stocks were making that in a day. A company that pays a 2% dividend looks good as long as the share price doesn't drop (page 107). "In an environment where stock prices are being questioned, dividend checks are king," says Steve Galbraith, equity strategist at Morgan Stanley.

Investors need to keep a closer eye on the calendar. During the bull market, many parents of college students invested in stocks until the kids mailed their tuition checks. That strategy backfired for families facing college-tuition bills now. For those with students with at least three to four years to go until they enter college, there is still time to hone exit strategies and come up with a completely new approach (page 104).

Many investors thought that they had adequately diversified their stock portfolios by investing in a Standard & Poor's 500-stock index fund. But since March, 2000, the S&P has lost more than 40% of its value. Those who took a broader view and diversified beyond the S&P—into real estate investment trusts and small-cap value—have fared better (page 106). And if diversification doesn't protect you enough, put options can, for a price, floor under your investments (page 106). In the 1990s, we knew stocks were risky, but we never felt the pain. Sell-offs were short-lived. But now we're in the third and most volatile year yet of a bear market, and we're bruised. Here are some strategies that can help heal your wounds and show you a few ways you won't get pummeled again. ■

Getting that 401(k) In Sync with the Times

A tactical approach to your portfolio

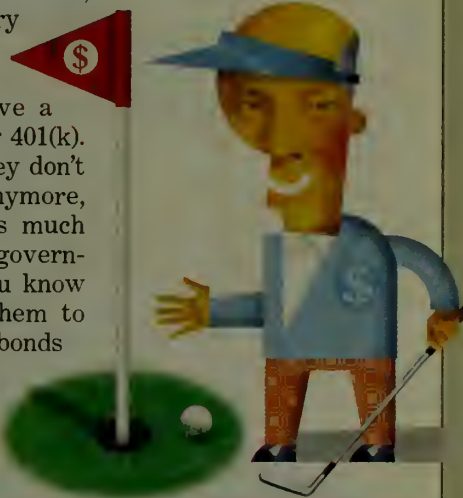
BY LEWIS BRAHAM

How should you invest your retirement dollars? That depends on your age, your risk tolerance, and your financial goals. But it also varies with what you assume will be the long-term average annual rate of return for stocks. Until recently, most planning tools would use about 10%—the average for the past 75 years—unless you specifically substituted another figure.

Now, the defaults are dropping, too. For instance, T. Rowe Price's retirement calculator assumes that large-cap stocks will deliver 9% a year, lower than the 9.7% average return for stocks from 1926 through July 23 of this year. Even that may be too high. "Almost every money manager we talk to says a reasonable rate of return for the S&P 500 index going forward is in the 7%-to-7.5% range," says Jeremy DeGroot, director of research at Litman/Gregory Asset Management, a mutual-fund-research and money-management firm.

Such reduced expectations can have a profound effect on how you invest your 401(k). If stocks deliver only 7% over time, they don't look so attractive relative to bonds anymore, and you may not wish to commit as much money to them. After all, long-term government bonds yield around 5%—and you know you'll get your money if you hold them to maturity. Investment-grade corporate bonds pay 6.5%, and high-yield bonds more than 11%. Sure there's more risk in those bonds, but not as much as in some stocks. That's why DeGroot has been recommending high-yield-bond funds as a substitute for equity.

There's a term for moving money around to take advantage of changing valuations and risk: tactical asset allocation. For such a strategy, an investor makes a forecast on an asset class or sector and overweights or underweights it accordingly. The moves are usually short-term: They end when the extremes in valuation return to normal—and they're



TWEAKING YOUR ASSET ALLOCATION

You may have a long-term asset allocation plan, but many advisers suggest adjusting it when short-term opportunities arise. Some options:

	CONSERVATIVE PORTFOLIO		MODERATE PORTFOLIO	
	LONG-TERM TARGET ALLOCATION	SHORT-TERM TACTICAL ALLOCATION	LONG-TERM TARGET ALLOCATION	SHORT-TERM TACTICAL ALLOCATION
INVESTMENT GRADE BONDS	60%	43%	40%	29%
HIGH-YIELD BONDS	0	20	0	17
LARGE-CAP STOCKS	30	21	40	27
SMALL-CAP STOCKS	5	6	8	10
FOREIGN STOCKS	5	5	12	12
REAL ESTATE REITS	0	5	0	5

Data: Litman/Gregory Asset Management

small bets on the margin. You never jettison your entire equity stake to buy junk bonds.

Tactical allocation is the next step after the more familiar strategic asset allocation. That's the process in which you determine an allocation of stocks, bonds, and cash—based on your risk tolerance, time horizon, and investment goals. But lately, because the market has been so volatile, it may be advantageous to tweak allocations on the margin.

How much shifting should you do? That depends on how confident you are in the call you're making. DeGroot, who does this for a living, will shift as much as 20 percentage points away from his clients' target allocation (table,

page 103). Jerry Wade, a Minneapolis financial planner, overweights or underweights assets as 5% in stocks relative to bonds, but more shifting within the asset classes might tilt more towards value stocks, or towards growth or international or small stocks," he says.

The moves can be subtle as well. You might decide to leave your current holdings unchanged but direct future 401(k) contributions to assets that seems the most promising. That could be junk bonds, real estate investment trusts, or even beaten-up tech stocks. Regardless of what they are, your tactical shifts will require changes in your thinking.

Damage Control For Junior's 529 Plan

How to protect your kid's college funds

BY CAROL MARIE
CROPPER

Michael Kirlin of Tenino, Wash., watched as the money he had set aside for his three young children in tax-deferred 529 college savings plans shrank with the stock market. Then in March, he pulled out the \$6,100 left of \$6,600 he had put in a year before and stashed it in prepaid plans to cover tuition and fees when his children go to college. With tuition rising, he figured a guaranteed payback was a lot better than a loss.

Parents who have invested in those newly popular state-sponsored 529 plans have been slammed by the market along with everyone else. If your child is still in elementary school, you have time for a market rebound. But if Junior is within three or four years of college, you're in tough shape unless you've been shifting gradually into conservative investments such as money markets and bonds.

Even if college is years away, it's hard to be happy if your 529 plan was heavy into tech or other hard-hit sectors. One technology fund offered by Arizona was down almost 41% this year through June 30. Even some of New York's stock portfolios have losses approaching 22%.

For those in search of a good night's sleep, there are alternatives. One is to do what

Kirlin did: Roll your money into one of the prepaid 529 plans offered in 20 states. The plans are set up so that if you put in a specified amount of money, either periodically or in a lump sum, they guarantee to cover the cost of tuition and fees in that state's public schools, no matter what inflation brings. They allow you to get the sum in cash if your kid picks a school in a different state. The downside: You give up the hope of making big profits on your contributions in any new bull market.

Another option is to switch some or all of

your money from stocks to money-market bond funds, or to the guaranteed portfolios offered by some states. Pension fund giant CREF, which manages 529 plans in New York, California, and 11 other states, has an investment option that guarantees your principal and a minimum 3% annual return. Like other managers, CREF also offers traditional age-based portfolios that automatically shift your savings away from stocks and toward bonds and money markets as your child gets older, relieving you of the burden of making the shifts.

Finally, Joseph Hurley, founder of SavvyCollege.com, a Web site focused on 529 plans, offers a tax balm for sore investors. Those 529 plans worth less than what was originally invested can take out the money without fear of an Internal Revenue Service's early withdrawal penalty, he says. That's because the 10% penalty applies only to earnings. The plan may also levy its own penalty.

The IRS hasn't decided the tax treatment for losses on 529 plans. It may treat them as they do other capital losses. But Hurley guesses it will regard them as miscellaneous itemized deductions. You can't start deducting such items until they total 2% of adjusted gross income.

If you want to reopen a 529 for that child, you have to wait 60 days or it will be considered just a rollover of the old account (and therefore not a loss) rather than a new account. Things could get complicated if you have already given the maximum \$11,000 annual tax-free gift to that child. The IRS might consider any money you deposit in a new 529 as another gift, in which case you may want to wait until January before starting anew.

STRATEGY FOR COLLEGE SAVERS

► Move all or part of the 529 funds into bonds or money-market investments, especially if your student is within three or four years of entering college.

► Consider switching your savings into a prepaid tuition plan. At least your child's tuition fees will be covered, and not subject to the whims of the stock market.

► If your account has less than \$10,000 invested, you could cash out and avoid a tax loss.



VIRGIN MEGASTORE IS PLAYING TO WIN.



IBM

@business is the game. Play to win.™

Winning on the sales floor: Virgin Megastore is one of the world's most innovative retailers. And now, Virgin Megastore shoppers in North America can preview over 250,000 CDs and 11,000 DVDs on demand using Web-based kiosks in stores. IBM and IBM Business Partners (in this case, Retail Store Systems) are working with thousands of companies to build innovative solutions like this one. Winning in e-business means improving service – wherever your customers are. Get in the game at ibm.com/e-business

Index Funds Beyond the S&P

You can track real estate, mid-caps, and more

BY LEWIS BRAHAM

With the Standard & Poor's 500-stock index down to 1997-98 levels, many of the millions of folks who automatically plunked money into funds based on that stock index may be wondering if index investing is a bust. "Most people, when they think of indexing, think of the S&P 500," says Gus Sauter, who heads Vanguard Group's index funds. "But there are many other indexes."

Indeed, if you had invested in Vanguard Mid Capitalization Index Fund, which tracks the S&P MidCap 400 index, you would've eked out a 3.9% three-year annualized return as of July 29, trouncing the S&P 500's 11.4% annualized loss and beating over 80% of other mid-cap funds. If you had bought a real estate stock index fund, you would've earned around 12% per year. Plus, index funds' low management fees and trading costs give them an edge of more than 1% a year over actively managed funds.

Keep in mind that by betting on a narrow market sector such as real estate, you're obeying the letter, but not the spirit, of indexing. Devotees of indexing, such as Vanguard founder John Bogle, argue that since few people can predict which sector or stocks will lead the market upward, investors are best off with the broadest possible market index so they can get at least a market rate of return. In U.S. stocks, the Wilshire 5000 index, which tracks more than 6,500 stocks, is the broadest.

But no matter what Bogle says, many investors prefer more narrowly based indexes. That's usually because they're uncomfortable with the companies that account for a big share of the broad indexes' value. Index funds hold stocks in the same proportion to share of total market capitalization. In the Wilshire 5000, for instance, the 100 largest stocks currently ac-

count for 56% of capitalization. At the W peak in March, 2000, 44% of its value technology and telecommunications stood when those sectors tanked, the Wilshire down with them, falling at a 10.2% annual rate over the past three years.

As their market capitalizations fell, telecommunications shrank to 17% of the Wilshire 5000, just under 20% of the S&P 500. But even if they could remain a drag on returns if they continue to underperform. If you worry about telecommunications, technology, or other sectors, remain dogs, consider choosing indexes that exclude those sectors.

Using Options To Create a Cushion

They can limit your losses

BY ANNE TERGESEN

In a bull market, no one cares about downside protection. Now, though, you may want it a lot—and that's why it may pay to think about options. These instruments offer protection for a limited time, typically from one to two to three years. Options can be expensive, especially those with the long terms, so they're not for everyone. Still, if you think your holdings will rebound but are nervous about being wrong—or if you're hesitating to sell for tax or other reasons—options may be for you.

One strategy for insulating your portfolio against sell-offs is to buy a put (that is, an option on a stock market index). When you buy a put on an index, you lock in a value—say 8,200 for the Dow Jones industrial average. Because a put appreciates as its underlying index declines, it's possible to engineer that the profits on your options will roughly offset your portfolio's losses, depending on the value you select and how closely your portfolio tracks the benchmark.

To get the most protection for the least expense, choose a strike price that's close to the index's current level. For example, a contract to insure against the Dow falling below 8,200 by Dec. 20 cost \$370 on July 29 (table), vs. \$300 to protect against the index closing at 11,000. Options prices are typically quoted as a percentage of their actual cost, so you'll see these contracts listed at \$3.70 and \$30.20 instead of \$370 and \$3,020.

If the Dow falls to 7,200 by the time your option expires, a put that guarantees you a value of 8,200 will yield a \$1,000 profit. Subtract the \$370 you paid for the option, and you have a net profit of \$630. If you buy enough contracts to shield your entire nest egg, you can offset much of your portfolio's losses. Of course, if the index



WHAT ELSE IS OUT THERE?

Here are just a few examples of index investing that many people may not be aware of:

MUTUAL FUNDS

- ▶ Fidelity Spartan Extended Market Index FSEMX
- ▶ Vanguard Emerging Markets Index VEIEX
- ▶ Vanguard European Stock Index VEURX
- ▶ Vanguard REIT Index VGSIX

EXCHANGE-TRADED FUNDS

- ▶ iShares MSCI EAFE Index EFA
- ▶ iShares S&P MidCap 400 Index IJH
- ▶ StreetTracks Dow Jones U.S. Small Cap Growth DSG
- ▶ StreetTracks Dow Jones U.S. Small Cap Value DSV

DOWNSIDE PROTECTION

say the Dow Jones Industrial average is at 8,500 and you want to protect against a fall below 8,200.

1 put option on the Dow, with an exercise price of \$8,200 expires on Dec. 20, 2002

ost is \$3.70, or \$370 per contract (plus commissions)

ec. 20, if the Dow is above 8,200, the option es worthless

e Dow is between 8,200 and 7,830, the option has value, ou haven't recovered its \$370 cost

n 7,830, you're making money on the option

Data: Chicago Board Options Exchange, *BusinessWeek*

8,200, your option will expire worthless. u are heavily exposed to one stock and ncerned about sell-offs, put options can your downside while preserving your to profit from a rebound. Say you bought ars ago at \$40 and want to keep it, be- ou think the stock is worth more than its price of \$71. To limit your risk, you can put giving you the right to sell IBM for e put that expires on Sept. 20 cost you n July 29—which really means \$265 per res.

The option's cost, known as a premium, reduces any profit you realize on the stock. But because the option guarantees you a \$65 sale price, you'll be able to rest easy if IBM is hammered before the put expires. And if IBM soars, you simply keep your stock.

You can also earn some income while holding your shares by selling call options. Say you bought IBM at \$65 and think it's worth at least \$75. Sell a call giving the buyer the right to acquire your shares for \$75 by Sept.

20. This will net you premium income—on July 29, this amounted to \$2.50 a share. If IBM rises above \$75, you'll be forced to sell. But that's not bad, since you'll realize a \$10 gain on the stock, plus the \$2.50 premium. That's a 19% return on your \$65 investment.

If IBM stays below \$75, the call will expire worthless since no one will want to buy your stock for \$75. Once the option expires, you can sell new ones and collect more premiums. In a flat market, that may be your best hope for making money. ■

Cold, Hard Cash, us on Dividends

Prices fall, yields are rising

MARGARET POPPER

ere's an upside to the mar- s downswing, it's that divi- ls are back in fashion. Now oughly 2%, the divi- d yield of the Stan- z Poor's 500 is almost its late-2000 low. are plenty of solid companies 3% or more (table). That beats verage money market return of f shares tumble, your total return won't be by the dividend yield. But owning a good nd-yielding stock lets you collect hard cash ou wait for share prices to rebound. t go straight for the companies with the t dividend yields. When the dividend pay- a percentage of the stock price soars, it's e the stock has cratered and the market t believe the dividend can be sustained. the case with Dynegy. At its July 29 price und \$1.20 a share, the energy trader's 30¢ e per year in dividends produced a yield of But the troubled company has announced to cut the dividend in half. ome seekers should examine the steady-

ness of dividend payouts, the company's consistency in increasing them, and its capacity to pay them out of profits. Dividend histories are usually available from company Web sites or www.businessweek.com. Tobacco company Philip Morris has historically paid out on average 59% of its earnings as dividends. But profits have risen faster than dividends lately, so the share of profits paid out in dividends has actually dropped to 53%, according to Thomson Financial/First Call. Plus, Philip Morris has an average annual dividend growth rate of around 7.5%. With its stock at

\$47.20 on July 29 and its annual dividend of \$2.32, it had a 5% dividend yield.

In another traditional dividend-paying sector—real estate investment trusts—top players such as Equity Office Properties are yielding around 8%. But with commercial rents dropping around the country, investors should favor REITs that are diversified in property type and location, says Mary Farrell, senior investment strategist at UBS PaineWebber.

With many stock prices down 50% in recent weeks, now is a good time to pick up a cash return. Just make sure the earnings and dividend track record of the companies you pick are sound. ■

DIVIDENDS DON'T DISAPPOINT

COMPANY/SYMBOL	DIVIDEND YIELD*	PRICE*
TXU TXU	5.8%	\$41.14
TUPPERWARE TUP	5.0	17.77
PHILIP MORRIS MO	4.9	47.20
KEYCORP KEY	4.6	25.81
DOW CHEMICAL DOW	4.4	30.65
GENERAL MOTORS GM	4.3	46.09
H.J. HEINZ HNZ	4.3	37.90
CUMMINS CUM	3.7	32.81
MERCK MRK	3.0	48.46
GENERAL ELECTRIC GE	2.4	30.45

*Annualized yields and stock prices are as of July 29, 2002

Data: Standard & Poor's


**NISSAN
350Z**

 BASE PRICE
\$26,809

The company isn't
ing about how fast
Z zooms from 0 to
But it has thoughtfu
a stopwatch into the
ment panel, and ent
are clocking wel
six seconds
power is a
at higher sp
well; E
sixth gear
enough
and-go to
other cars
highway.

Sure, Nissan
make compromi

keep the price down, but not where it
Every model has the same 287 ponies,
trast with the underpowered engines on
pensive versions of the Porsche Boxs
BMW Z3. There's no switch to soften t
pension for highway cruising, and yes, th
a bit stiff. But the payoff comes when yo
it around a curve a little faster than
prudent. The tail end stays put.

I loved the cockpit. The driver's seat
and snug, with big side bolsters to ke
firmly planted around those curves. The
ger seat is less aggressively styled, do
more for comfort. The instrument panel
and simple and backlit in orange; its
gauges move with the steering wheel as
it for the best driving position. An ad
three gauges are mounted center dash
vidual pods, just like in the original Z.

You can see where Nissan skimped
car. There's no glove box, unless you
deep, horizontal compartment behind t
senger seat. A single dash-mounted cu

is the cheapest plasti
and it hit the floor w

cidentally struc
passenger's

Two other cu
ers are in the
console, but

the seats. T
plenty of room

neath the hatchback,
steel cross-strut—need

stiffness—bisects the space, making it we
useless for luggage. Another problem: Th
hatchback compromises rear visibility, and
about seeing anything in that blind spo
your left shoulder.

There's no question that the new Z, w
Audi TT-like good looks, is a head-turner, fo
all manner of thumbs ups and hurried cor
tions at stoplights. Someday, this car, too,
ly to evoke the affection, the stories, an
reminiscences that the restored 240Z did v
took it to a Kool & the Gang concert this
mer. Everyone, it seems, loves the origi
They'll like this one, too.

Another Classic in the Making?

The new Z retains the spirit and power of the original

BY LARRY
ARMSTRONG

Nissan Motor struck a chord with the Datsun 240Z, first introduced in 1969 as a 1970 model. It was stylish—a Jaguar lookalike. It was fast—150-hp under its long, sloping hood. Most of all, it was affordable. At \$3,526, the Z was just a couple of dollars more than the average new car that year and about half the price of competing sports cars.

Now, Nissan has done it again. At a time when true two-seat sports cars start at \$42,350 for the bargain-priced Chevy Corvette and go up from there, Nissan's new 350Z will carry a base sticker of just \$26,809 when it goes on sale in mid-August. That's only about \$1,000 more than what the average new car fetched last year, according to the National Automobile Dealers Assn.

Over the past month or so, I've driven pre-production versions of most of the new Z models, from the base car to the top-end \$34,619 Track Model with oversize brakes and lightweight aluminum wheels. For comparison—O.K., for fun—I also spent a week in a fully restored 1972 chrome-yellow 240Z.

Cars have come a long way from the days before air bags, computer-controlled engines, and power-robbing pollution controls. The new Z is no exception: It's a heavy car, some 3,200 lbs., but Nissan has given it a 287-hp engine with plenty of oomph. And there's lots of the no-compromise spirit of the earlier car.

THE 240Z: Base
price in 1969:
\$3,526



Every model has
the same 287-hp
engine. That
contrasts with the
reduced power of
less pricey
versions of the
Porsche Boxster
and BMW Z3

ADVICE FOR RUDY'S DY-IN-WAITING



Ms. Judith Nathan
New York, N.Y.

Dear Ms. Nathan:

We don't know each other, but I recently read that your boyfriend, Rudy Giuliani, reached a \$6.8 million divorce settlement with his ex, Donna Hanover. Forgive my presumptuousness, but I couldn't help thinking that after two years together—much of it (given September 11, his prostate cancer, and his humiliating public divorce battle) spent under the most trying circumstances imaginable—you and he might soon be ready to tie the knot. If you do, as much as he says he loves you, I'd wager he'll insist on a pre-nup.

Let's face it: When he married Donna in 1984, he was just an ambitious prosecutor, with no extraordinary assets to shield. But now, he's a national hero, a man who soothed us through one of the worst calamities in U.S. history. For that, he has earned the right to charge \$100,000 a pop on the rubber-chicken circuit, spill his guts in a multimillion-dollar book deal, and do who knows what else to rake in the dough. If you think he isn't going to want financial protection this time around—if only to secure the inheritance rights of his children, Andrew and Caroline—you're not only blinded by love, you're rendered senseless by it.

I'm no lawyer, but in my capacity as a columnist on women's issues, I've learned a lot about pre-nuptial agreements. So let me give you a bit of advice: A pre-nup is executed typically for the benefit of the partner with more money. Mere mention of the word can be a romance killer. But if it comes down to a choice between the contract or the guy, sign the papers—and make sure you draft something that's as advantageous to you as possible.

Start with a good matrimonial attorney—and choose him or her yourself. Don't just hire one of Rudy's chums (unless you think you may want to get the agreement nullified someday by playing the conflict-of-interest card). Since pre-nups are thrown out mostly on the basis of legal technicalities, you need someone who stays on top of the law. For example, New York recently changed the language in the notary section for all marital agreements. So if you had an existing agreement and didn't have the revised language, it wouldn't have held up in court. Other technicalities that cause pre-nups to disintegrate include the failure of a spouse to disclose all assets and not allowing ample time (say, at least a month) to review the document before marriage.

Insist on a "sunset" provision. That's an expiration clause that voids the contract as of a cer-

tain date. These provisions are often used as negotiating tools: The partner with fewer assets can argue that if the marriage lasts, say, 10 years, the couple is likely to stick together 'til death do them part. Indeed, that's probably what Jane Welch thought when she married former General Electric CEO Jack Welch in 1989. Then, last December, she discovered that her husband was having an affair with a *Harvard Business Review* editor. Now, she's thanking her lucky stars that her pre-nup expired in 1999—since she's undoubtedly going to get much more of his half-billion-dollar-plus fortune than she would have been entitled to otherwise.

Sunset clauses differ depending on what you want to accomplish. Some simply nullify the agreement. Others protect certain income and assets from ever becoming joint marital property even after the pre-nup expires.

I would also in-

GIULIANI AND NATHAN: *His lectures go for \$100,000 a pop*



clude some additional clauses. You can spell out almost anything: who gets the Yankees tickets, custody and visitation rights to the dog. The more clauses, the better—to protect your interests and increase the chances that some judge down the line will find one of them distasteful and throw the whole contract out of court.

One last piece of advice: Pre-nups are like wills—a change of circumstances warrants a change in the document. If the two of you buy a house in the Hamptons, you want to be sure the pre-nup recognizes your share.

Take it from me, Judy: Stay one step ahead, and you won't be left behind. Good luck. ■

BusinessWeek online

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IT'S NEVER TOO LATE TO LEARN GOOD HABITS



BY ROBERT BARKER

rb@businessweek.com

Three recent books repeat investment lessons that, had they been more widely followed in the '90s, would have left us licking far fewer wounds

The other day at a Dollar General store, where I had stopped to get a candy bar, the cashier shot me a stern look. "Too late to be reading that," she said, giving two swift thumps to a book I had with me, *The Four Pillars of Investing*. Had she stolen a peek at my portfolio? Or had this woman, whose gray hair identified her as one of Florida's working retirees, resigned herself to eternal toil at Dollar General? Either way, I figured the best response was an upbeat one, so I muttered something about hope over experience.

Investors all over might be forgiven right now for never wanting to pick up another book on investing. Yet three recent titles restate lessons that, had they been more widely followed in the '90s, would have left us far better off now. Along with *Four Pillars*, by William Bernstein, they are Larry Swedroe's *Rational Investing in Irrational Times* and Frank Armstrong's *The Informed Investor* (table).

What's curious is that the authors agree on key issues—index investing is good; most of professional Wall Street and nearly all of the financial media are bad—and they promote one another's work via cover blurbs and mid-chapter asides. Yet they're also in a polite rivalry for book buyers. While you might want to read any one of these books, believe me, you don't need more than one. So, with an eye toward picking which is best for which reader, I examined each.

Four Pillars, which follows Bernstein's superb first book, *The Intelligent Asset Allocator*, is the most ambitious. A practicing neurologist who moonlights as an investment adviser, Bernstein sets out to fix what he says he failed at in his earlier book. That is, to explain modern portfolio theory to the general public. No small task. I am sorry to say that, at this, Bernstein has yet to succeed.

While he presents most of what's worth knowing about the theory and dangers of investing, he

quickly leaves general readers behind. For ample, Bernstein describes the upside-down relationship of bond prices and yields (as go up, prices fall). But in doing so, he slips term "long-duration bonds" with no explanation for another 226 pages. It's as if he were explaining brain functions without defining synapse. Even if it asks us to read more, Bernstein's first book is better—third shorter.

Far less ambitious—or learned—is Swedroe's *Rational Investing*. Another serial author and investment adviser, Swedroe lays out 52 common investor mistakes, one per chapter, along with ways to avoid them. He swiftly slays the tired notion that active management beats passive indexing in bear markets, and he focuses on the truest goal—aftertax returns. But it gets a bit repetitive, and my eyes kept glazing over.

This book is perhaps best read one chapter per day.

Frank Armstrong encouraged Swedroe and Bernstein to write their first books. A former pilot who became an insurance sales broker, and, finally, a dependent investment adviser, Armstrong used to detest Wall Street's commission structure. In 1997, he published a free book, *Informed Investor*, which is an updated and expanded version that makes most of the points about index funds and the Street's greed in ways as the other two do, but it's better organized than Swedroe's. The style is more accessible than Bernstein's.

Had you given any of these guys money to run, each might have built you more or less the same portfolio. The chances are you

would be resting pretty easy amid the current unpleasantness. These advisers counsel close attention to diversification across many asset classes and funds, including bonds and even small foreign company stocks. Just 10% of the equities in Armstrong's portfolio, for example, represent Standard & Poor's 500. Too late to learn to invest this way? No, and any one of these books will show you how.



GOING BACK IN THE WATER

The Four Pillars of Investing

William J. Bernstein, McGraw-Hill (240pp, \$27.95)

Rational Investing in Irrational Times

Larry E. Swedroe, St. Martin's Press (384pp, \$24.95)

The Informed Investor

Frank Armstrong III, AMACOM (288pp, \$25.00)

BusinessWeek online

For barker.online, go to

www.businessweek.com/investor/ and click on "Colu

PRIVATE MARTHA?



Gene Marcial

could
believe
ills at
Stewart.
Perelman may
bigger bite
Worldwide.
re rights
t Intergraph
er

What's Martha Stewart to do? The chairman and CEO of Martha Stewart Living Omnimedia (MSO) is under siege on all fronts: The Securities & Exchange Commission is looking into her sale of ImClone System shares for possible insider trading, stockholders are incensed by the collapse of MSO shares—from 20 in mid-March to 8.21 on July 31—and analysts have downgraded the stock and cut earnings estimates.

Would you blame Stewart, then, if she took her company private? Several in the Stewart circle say she has been talking to investment bankers about a leveraged buyout to resolve some of her woes. "With MSO's shares plunging, it would be strategically wise of Martha to buy all of MSO," says a banker who didn't want to be identified. He thinks an LBO at 12 a share would be fair.

Some analysts also think an LBO would be logical. "I would consider it if I were in her shoes," says Laura Richardson of Boston investment firm Adams, Harkness & Hill, who dropped her MSO rating from "buy" to "reduce." Richardson, who doesn't own shares, says the future outlook is worse than she originally thought. Adams Harkness has no business ties with MSO. Kathleen Heaney of investment firm Brean Murray says an LBO is a "natural" for companies with two classes of stock. Stewart owns 66% of the common and nearly all of the voting shares.



LA STEWART:
Under siege

Heaney, who owns no shares, has also cut her estimates due to the ImClone mess. But based on a sum-of-the-parts valuation, she rates the stock a buy. She cut her 2002 estimates from 56¢ to 40¢ a share, and for 2003 from 73¢ to 55¢. Brean has no business links to the company. MSO, which markets the Martha Stewart brand across a broad range of media and retail outlets, declined comment.

EYEING LUCRE FROM LICORICE

A funny thing happened to Ron Perelman on the way to a sweet deal: He had to unravel it. In an out-of-court settlement on July 29, Perelman canceled a pact he struck in 2001, in which he sold his 83% stake in Panavision to M&F Worldwide (MFW), of which he owns 53%, for \$129 million, or 17 a share. At the time, Panavision, a maker of movie cameras, traded at 4. M&F shareholders howled: They accused Perelman, who also controls Revlon, of self-dealing—and sued him. After more than a year in court, Perelman agreed to scuttle the deal: He took back his Panavision shares and re-

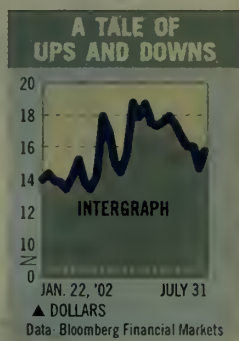
turned M&F's \$80 million, plus \$10 million and \$48 million worth of M&F stock he got as part of the Panavision sale. The suit was initiated by Daniel Breen of Furtherfield Partners, a Houston hedge fund that owns more than 50,000 M&F shares.

Perelman's next move? "It's possible Perelman may take M&F private, so he could do what he wants with it," says Breen. Now trading at 5.50, M&F is "an attractive company in a very good niche business," says Breen, who puts the value of its assets at 15 a share. He says Perelman bought his M&F stake in 1996 at 19. Breen estimates that M&F, the top producer of licorice extract used by tobacco and drug companies, generates free cash flow of \$30 million a year, or \$1.66 a share, and has little debt. M&F, whose customers include Philip Morris and R.J. Reynolds, controls 80% of the licorice market, notes Breen. He sees M&F earning \$1 a share in 2002—without Panavision. In 2001, M&F earned only 24¢, because of losses at Panavision. Perelman declined comment.

INTERGRAPH: SET TO MILK ITS PATENTS

Intergraph (INGR), a provider of graphics software and services, has turned out to be a rewarding "patent play." The company holds valuable patents on microprocessors for high-end workstations. It is these patents that have attracted interest in the stock. Trading at 8 last October, shares hit 19 in mid-May, before easing to 15.90 on July 31. "Because of the patents, Intergraph is on the verge of collecting substantial royalty and licensing fees," says Jan Loeb of Jefferies, who rates the stock a buy, with a 12-month price target of 24. He doesn't own shares, and Jefferies hasn't done banking for Intergraph.

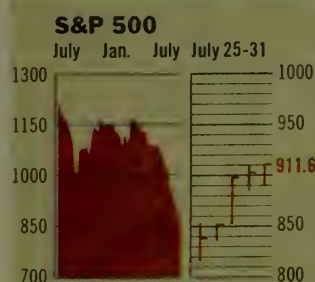
In April, Intel settled a patent-infringement suit that Intergraph filed in 1997: It agreed to pay Intergraph \$300 million. "The settlement opens the door for Intergraph to claim license fees, which could total hundreds of millions, from companies using Intel's Pentium processor in their systems," says Loeb. And Intel faces another Intergraph suit in Texas. Loeb figures a win in this second case could produce a further \$250 million. Loeb sees Intergraph earning 40¢ a share in 2003—not including new licensing fees arising from the settlement—up from an estimated 14¢ in 2002. As part of the deal, Intel has agreed to pay Intergraph \$150 million if Intergraph prevails, and a further \$100 million if Intel loses on appeal.



BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:40 p.m. EST on CNNfn's *The Money Gang*.

Stocks



COMMENTARY

The stock market rallied for a second week in a row, as investors continued to shrug off their blues and focus on an increasingly positive profits outlook. Not even a sharp slowdown in second quarter Gross Domestic Product dampened their spirits. The S&P 500, up 8.1% for the week through July 31, led the charge. The Dow rose 6.7%, the Nasdaq 2.9%.

Data: Bloomberg Financial Markets
Reuters

U.S. MARKETS

	July 31	Week	Year to date	Last 12 months
S&P 500	911.6	8.085	-20.6	-24.7
Dow Jones Industrials	8736.6	6.657	-12.8	-17.0
Nasdaq Composite	1328.3	2.948	-32.0	-34.5
S&P MidCap 400	441.7	6.68	-13.1	-13.6
S&P SmallCap 600	198.6	4.396	-14.5	-13.1
Wilshire 5000	8616.9	7.587	-19.5	-23.1

SECTORS

	July 31	Week	Year to date	Last 12 months
BusinessWeek 50*	555.3	8.5	-23.9	-32.9
BusinessWeek Info Tech 100**	279.4	2.5	-33.4	-35.6
S&P/BARRA Growth	467.4	7.6	-21.4	-23.0
S&P/BARRA Value	441.1	8.6	-20.1	-27.0
S&P Energy	189.9	7.5	-10.2	-16.3
S&P Financials	309.7	11.2	-12.8	-17.9
S&P REIT	97.2	13.1	4.1	5.6
S&P Transportation	176.4	7.4	-10.5	-13.1
S&P Utilities	105.5	13.1	-27.7	-40.7
GSTI Internet	64.6	1.4	-38.4	-44.8
PSE Technology	453.5	2.1	-34.0	-34.1

*Mar. 19, 1999 = 1000 **Feb. 7, 2000 = 1000

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Conglomerates	8.1	37.6
Biotechnology	8.1	34.1
Photographic Products	5.5	31.6
Casinos	4.7	20.5
Tobacco	4.3	19.4

GLOBAL MARKETS

	July 31	Week
S&P Euro Plus (U.S. Dollar)	878.6	7.7
London (FT-SE 100)	4246.2	12.4
Paris (CAC 40)	3415.4	13.0
Frankfurt (DAX)	3700.1	1.9
Tokyo (NIKKEI 225)	9877.9	-0.7
Hong Kong (Hang Seng)	10267.4	3.0
Toronto (TSE 300)	6605.4	3.5
Mexico City (IPC)	6021.8	0.2

FUNDAMENTALS

	July 30	Wk
S&P 500 Dividend Yield	1.71%	1
S&P 500 P/E Ratio (Trailing 12 mos.)	32.0	2
S&P 500 P/E Ratio (Next 12 mos.)*	16.1	1
First Call Earnings Surprise*	1.46%	0

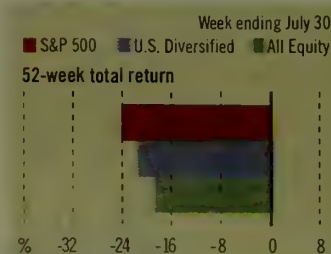
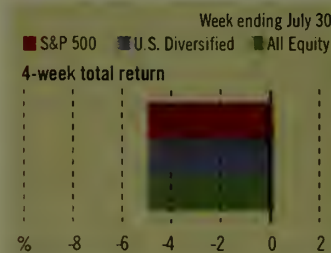
TECHNICAL INDICATORS

	July 30	Wk
S&P 500 200-day average	1085.9	109
Stocks above 200-day average	33.0%	1
Options: Put/call ratio	0.68	0
Insiders: Vickers NYSE Sell/buy ratio	3.12	3

WORST-PERFORMING GROUPS

	Last month %	Last 12 months %
Multi-Utilities	-30.1	Multi-Utilities
Paper Packaging	-26.3	Wireless Service
Constr. & Engineering	-21.0	Telecomms. Equ
Semiconductor Equip.	-21.0	Application Softw
Aluminum	-19.2	Electrical Equipr

Mutual Funds



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-week total return	%	52-week total return	%
Leaders		Leaders	
Health	3.5	Precious Metals	44.3
Technology	-0.9	Real Estate	10.0
Domestic Hybrid	-2.8	Pacific/Asia ex-Japan	6.2
Large-cap Growth	-3.2	Diversified Emerging Markets	1.2
Laggards		Laggards	
Precious Metals	-15.3	Communications	-49.7
Latin America	-11.6	Technology	-44.1
Natural Resources	-10.1	Utilities	-31.6
Utilities	-8.8	Large-cap Growth	-28.2

EQUITY FUNDS

4-week total return	%	52-week total return	%
Leaders		Leaders	
Monry. M. N. Wld. Biotech	16.7	First Eagle SoGen Gold	79.0
UBS Global Biotech Y	16.1	Rydex Dynam. Venture 100	78.7
Rydex BioTechnology Inv.	15.8	Matthews Korea	74.8
Smith Barney Biotech L	15.8	ProFunds UltraShort OTC	73.9
Laggards		Laggards	
U.S. Glob. Wld. Prec. Minls.	-23.5	ProFunds UltraOTC Inv.	-73.6
iShares MSCI Brazil Indx.	-23.0	Black Oak Emerging Tech.	-67.7
U.S. Global Investors Gold	-21.8	iShares Gold. Sachs Netwkg.	-64.3
Polynous Growth A	-18.7	Firsthand Commun.	-62.0

Interest Rates

KEY RATES

	July 31	Week
MONEY MARKET FUNDS	1.41%	1.43
90-DAY TREASURY BILLS	1.69	1.67
2-YEAR TREASURY NOTES	2.24	2.29
10-YEAR TREASURY NOTES	4.46	4.46
30-YEAR TREASURY BONDS	5.30	5.34
30-YEAR FIXED MORTGAGE†	6.44	6.34

†BancQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 30% federal tax rate.

	10-yr. bond
GENERAL OBLIGATIONS	3.88%
TAXABLE EQUIVALENT	5.54
INSURED REVENUE BONDS	4.07
TAXABLE EQUIVALENT	5.81

THE WEEK AHEAD

EXPORT-IMPORT PRICES Wednesday, Aug. 7, 8:30 a.m. EDT ► Import prices during July probably fell 0.1%, while export prices most likely held steady. That's based on the median forecast of economists surveyed by Standard & Poor's MMS, a unit of The McGraw-Hill Companies. In June, import prices slid 0.6% on a 6.6% drop in petroleum prices. Export prices in June were unchanged.

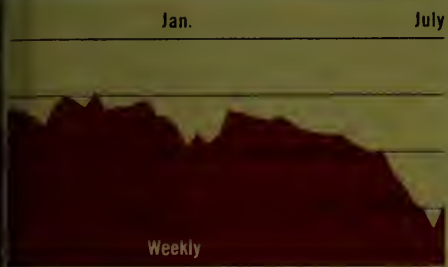
INSTALLMENT CREDIT Wednesday, Aug. 7, 3 p.m. EDT ► Consumers are forecast to

have added an additional \$8 billion of new debt in June. Nonrevolving debt rose by \$7.2 billion in May, the biggest jump since last December. Overall consumer debt rose by \$9.5 billion during May.

PRODUCER PRICE INDEX Thursday, Aug. 8, 8:30 a.m. EDT ► Producer prices of finished goods in July most likely increased by 0.1% for a second straight month. Excluding food and energy, core prices probably increased by a similar 0.1% in July, following a 0.2% increase in June.

PRODUCTIVITY & COSTS Friday, Aug. 8, a.m. EDT ► Output per hour working the second quarter is expected to have slowed to an annual rate of 0.1% while S&P's MMS forecasts quarterly labor costs to have increased by the first quarter, productivity slowed to an annual rate of 8.4% and unit labor costs dropped by 5.2% from the fourth quarter. Labor productivity is growing at a healthy pace, allowing for both real wages to increase with pressure on inflation.

BusinessWeek Fifty

THE
BUSINESSWEEK **50**

more than the market, rising 8.5%. Pacing all gainers was Dynegy, up 144.9%, as investors bid bankruptcy; energy providers Calpine and American Electric Power rose as well. Drugmakers, Pfizer, and Johnson & Johnson, climbed 16.4%, 16.0%, and 11.1%, respectively, as value hunters bought shares. The biggest loser? Xcel Energy, down 41.1%, on a debt downgrade.

COMPANY PERFORMANCE

	% change		Rank	Company	% change	
	Week	Since 3/1/02			Week	Since 3/1/02
Johnson	11.1	-13.0	26	Tenet Healthcare	7.7	-17.5
	5.7	-2.8	27	Household International	6.8	-17.1
	16.0	-21.0	28	WellPoint Health Networks	-5.6	17.6
	16.0	-44.1	29	Washington Mutual	11.6	15.0
	3.1	-12.6	30	Duke Energy	15.5	-27.8
	-6.9	-32.0	31	Kohl's	3.1	-2.5
	7.0	-4.3	32	Bed Bath & Beyond	-1.2	-7.2
	0.9	-16.4	33	Cardinal Health	12.4	-12.8
	5.1	-26.8	34	Centex	0.7	-18.0
Bergen	7.8	-1.0	35	American Electric Power	25.1	-24.9
Group	-1.2	20.9	36	Golden West Financial	10.3	3.1
	11.5	-0.5	37	Stryker	11.4	-17.7
	0.5	-38.2	38	Harley-Davidson	2.2	-7.6
ores	2.6	-20.7	39	PepsiCo	8.6	-15.0
	144.9	-90.6	40	Merck	16.4	-19.1
amics	-5.5	-11.0	41	Apache	5.9	-2.4
oleum	8.3	-12.5	42	Amerada Hess	4.3	-1.3
atories	10.7	-2.6	43	KB Home	3.2	5.9
	8.8	-4.3	44	First Data	1.5	-14.3
	30.8	-32.4	45	Tyco International	28.0	-56.0
Petroleum	9.2	0.9	46	International Game Technology	9.7	-13.7
	14.3	-11.9	47	Capital One Financial	-4.8	-35.7
	3.6	-7.7	48	Electronic Data Systems	11.5	-37.7
	8.8	-11.9	49	Nabors Industries	1.8	-14.0
	13.3	-25.9	50	Xcel Energy	-41.1	-70.6

Broadband Leaves the Head Office

BusinessWeek's upcoming Special Advertising Section will examine the latest developments in broadband and will take a look at the players to see what they are doing, and how they are doing it.

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- Cable modems and DSL lines
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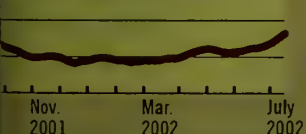
BusinessWeek online

For more investment data and the components of the production index, visit
www.businessweek.com.

Production Index

Change from last week: 0.9%
Change from last year: -1.7%

OUTPUT July 20=166.3 1992=100
Index is a 4-week moving average



Index continued its strong rebound. In of the four-week moving average, to 168.5 from 167.2. During the last adjusted output of auto and truck led the biggest increases. Also rising d electric power. Crude-oil refining antly. Steel and coal production suf- clines in the latest week, as did rail-

of the index components is at www.business-
week.com. Copyright 2002 by The McGraw-Hill

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Speaking Opportunities: Bhavna Shivpuri

Tel: (852) 2136 0522 Email: bhavna@dnmstrategies.com

website: www.dnmstrategies.com

PRC: Zhu Gang

Tel: (86) 10 68465550 68416622 ext. 210 Email: cema@public.bta.net.cn

REFORMS FAIL IF THEY PARALYZE CEOs

This magazine has strongly supported action to deal with the unprecedented wave of corporate crime and corruption that has devastated investors in recent months. The signing of the sweeping corporate-fraud reform bill by President Bush is welcome news indeed. The legislation not only creates a new oversight board to clean up the accounting profession, it holds CEOs personally responsible for their companies' financial numbers. Given the egregious behavior of some chief executives, there is a huge public demand for CEO accountability. But in the rush to get CEOs to personally sign off on financial statements, we must be careful not to enmesh them in a web of never-ending lawsuits. Demanding decent behavior from our corporate elite is one thing. Pushing CEOs into a permanent defensive posture that curbs their willingness to take reasonable business risks is quite another.

It is certainly true that restoring investor confidence is a top priority. The Securities & Exchange Commission is helping to reestablish that credibility by demanding that 947 CEOs and CFOs of the biggest U.S. public corporations attest under oath to the accuracy of their most recent financial statements at the time of their next SEC filing, which for most is Aug. 14. In fact, it is running a "credibility clock" on its Web site (www.sec.gov/rules/extra/ceocfo.htm) with all the companies listed and boxes for CEOs and their CFOs to sign in. As of July 31, it showed that nine have taken the pledge, from such companies as Corning, Qualcomm, PepsiCo, FedEx, and EDS. General Electric CEO Jeffrey Immelt is also signing.

But CEOs have a legitimate worry. Making sure their com-

panies' books are squeaky-clean before they sign on the line will inevitably lead to restatements of corporate earnings, especially between now and Aug. 14 and soon thereafter. In the past, restatements have often led to shareholder class actions. Many have been legitimate but others have not. Trial lawyers simply launch class actions whenever companies restate their earnings. And keep in mind that real people can disagree within bounds over accounting. The SEC's job is policing those boundaries. If it does its job—and it has recently—the courts don't have to be involved.

CEOs are also worried that since they will now be required to sign off on financial statements, their personal liability will increase in class actions. The Sarbanes-Oxley Act of 2002 increases criminal sanctions on chief executives who falsely certify their books and extends the time in which shareholders have to file suits alleging corporate fraud. A bigger concern is that CEOs believe they might be accused of perjury under the SEC mandate that they swear under oath to the truthfulness of their companies' books.

There's no denying that CEO liability is murky. Ultimately it will fall to the courts to clarify this liability and establish principles for reasonable class action suits against corporations as they restate their earnings in the new environment. The law must allow business to operate normally without fear of frivolous suits. The shock of widespread corporate crime has tarnished the credibility of our nation's corporate elite, hurt the stock markets, and threatened the economy. The goal now should be to make sure that the cure does not do the same.

MERRILL HAS TO FACE THE MUSIC

It's time for Merrill Lynch & Co.'s CEO David H. Komansky and President E. Stanley O'Neal to step forward and pledge to clean up the firm's conflicts of interest, which are so much in evidence in its dealings with Enron Corp. It is unseemly for the top leaders of one of the world's most prestigious financial institutions to stonewall on what congressional investigations are showing to be clear problems that urgently need solutions.

The conflict between the research and investment banking sides of Merrill were on display in Washington with revelations that its lead investment banker for Enron put pressure on the analyst covering Enron to improve his ratings of the company. In the end, that analyst left, another took his place, ratings of Enron went up, and so did Enron's investment banking business with Merrill. It didn't hurt that Schuyler Tilney, the Merrill investment banker, went on vacations with Enron's chief financial officer, Andrew S. Fastow, and counted him as a friend. Worse, Tilney's wife was a senior member of the Enron executive team at the time. Former CEO Kenneth Lay sent whistle-blower Sherron Watkins to Elizabeth Tilney when Watkins tried to get Lay to go public

about conflicts of interest in off-balance-sheet partnerships that concealed Enron's losses (page 8).

Watkins did not know at the time that Tilney was married to the man responsible for setting up one of the bank's most profitable partnerships—LJM2. Tilney and 95 other Merrill executives invested \$16 million of their own money in LJM2. Why? Because Fastow, Enron's CFO, was going to invest in it and he would be able to ensure a high return because he would be, in effect, negotiating with himself in his dual roles. Enron's board of directors voted to exempt him from conflict-of-interest bylaws. Merrill saw this as a virtue and said in its prospectus: "A. Fastow's dual role creates advantages for LJM2, LJM3, and Enron." Many institutional investors declined to buy into LJM2 because of Fastow's conflict of interest. Citigroup and J.P. Morgan Chase & Co., among others, also had a problem. Shame on them, too.

Merrill has already apologized for conflicts of interest in its dot-com financing in response to an investigation by New York Attorney General Eliot Spitzer. It's time to come clean on all its operations. There's a real problem here.

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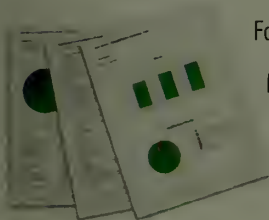
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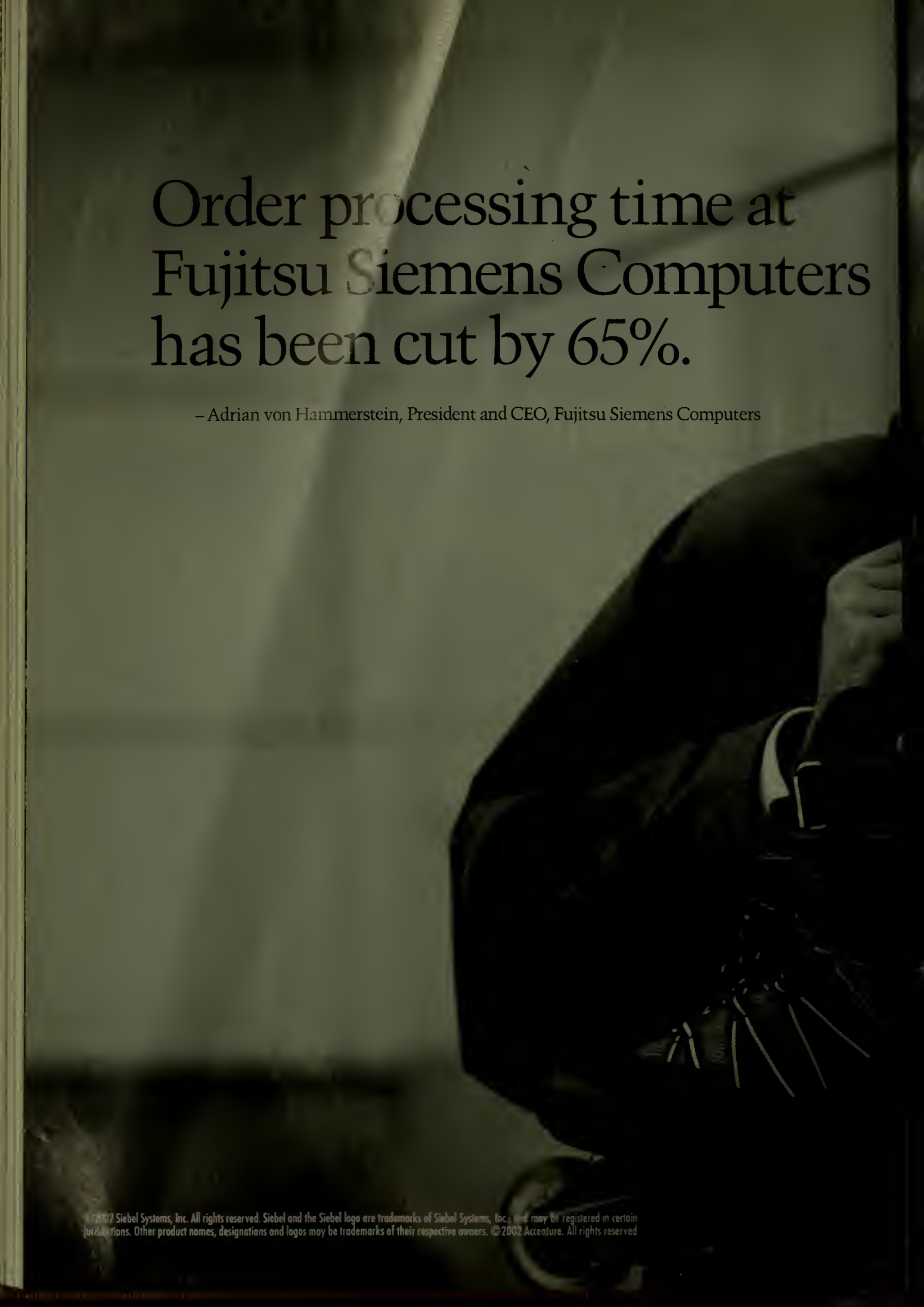
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With lots of bargains out there, deals are starting to come back page 32



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Up Front

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STREET NEWS

TELECOM'S 20/20 ANALYSTS

BELIEVE IT OR NOT, SOME Wall Street analysts did get it right. Case in point: three Morgan Stanley analysts who sounded an early alarm about Qwest Communications' accounting woes. Their June, 2001, downgrade, to neutral from outperform, was one

reason Qwest's share price lost 50% of its value during the summer of 2001. A furious Joe Nacchio, who resigned as CEO this year after the Securities & Exchange Commission began investigating the issues they raised, said at the time that the an-

PSYCH PROFILES

ANOTHER CROP OF SLEAZY CEOs?

HERE'S A WARNING FOR Corporate America: Adelphia's John Rigas, ImClone's Samuel Waksal, and Tyco's Dennis Kozlowski may be just the beginning.

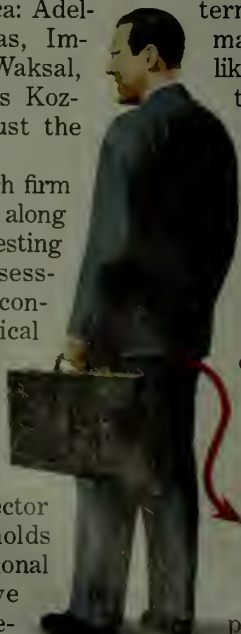
Executive-search firm Russell Reynolds, along with personality-testing firm Hogan Assessment Systems, conducted psychological profiles of more than 1,400 managers at large U.S. companies. Dean Stamoulis, an executive director at Russell Reynolds and an organizational psychologist, gave the execs 28 true-

or-false questions on rule compliance and interactions with others to gauge their level of integrity.

The troubling results: One out of eight execs can be termed "high-risk." That makes them far more likely to break rules than the remaining 87%.

"These are folks who believe the rules do not apply to them," says Stamoulis. "They're extreme in their lack of concern for others. They rarely possess feelings of guilt."

When he gave the same test to another group, he found more than 60% of them to be at high-risk for rule-breaking. Who were they? Inmates at a maximum-security prison. *Louis Lavelle*



TALK SHOW "The award is in recognition of his outstanding contribution to global economic stability and the benefit... realized from the wisdom and skill with which he led the U.S. Federal Reserve Board."—*Britain's Treasury announcing that Fed chief Alan Greenspan is to be knighted*

alysts "aren't the sharpest knives in the drawer."

They're looking pretty sharp now. Internet infrastructure analyst Jeffrey Camp went to Andor Capital Management in London, helping the hedge fund make tech investments. Telecom analyst Simon Flannery and accounting expert Trevor Harris won kudos at Morgan Stanley. "One of the most valuable calls an analyst can make is the non-consensus call that turns out to be right," says Dennis Shea, global director of equity research.

While both analysts expect to see more accounting problems to surface this year, Flannery thinks telecom is bottoming out. He raised his industry rating on July 24, saying he expects telecom stocks to keep pace with the broader market. Says Flannery: "We're just happy to help guide investors through the maze of telecom." Let's hope they keep their edges sharp. *Steve Rosenbush*

BIG LOSER

THE BEST MEDICINE

A SITE FOR SORE INVESTORS

IF COMEDY IS TRAGEDY, time, SellWhenIBuy.com, proof that the bear market has now lasted long enough to be funny. Created by time comic writer Roffman "to commiserate with my fellow investors," the Web site of Roffman's stock mishaps all their gruesome, scraping detail. A two-losers, Roffman bought stocks right before the crash, then stayed out of the market for 13 years or

get crushed again, including Nortel Networks and in 2000. On \$72,000 he invested, he has left.

Investors post their own stories, with the promise of a free "BIG LOSER" T-shirt the most pathetic tale of the week. Roffman also offers advice such as: "I say Get a job!"

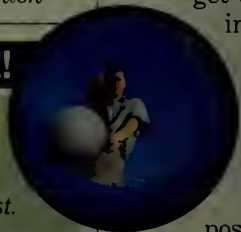
Investors who've lost their appetite for stocks can buy the site's gift shop for a squishy (\$65), a guitar case with a special coin anti-bounce lid (\$11.50), and an organ card (\$11.50). Notes Roffman: "These items have been fully selected and provided by effective money makers. In a few lucrative weeks, you'll earn back your dignity enough to get to the shower." *Lewis Brax*

THE LIST FORE!

Here are some of the best golf players among public company CEOs, as ranked by *Golf Digest*. For the full list, go to businessweek.com

RANKING		HANDICAP
1	SCOTT McNEALY Sun Microsystems	0.3
2	CURT CULVER MGIC Investment	2.9
3	WILLIAM JURGENSEN Nationwide	3.8
36	CHARLES SCHWAB Charles Schwab	8.4
50	JEFFREY IMMELT General Electric	9.6
72	MICHAEL ARMSTRONG AT&T	11.2
79	PHILIP PURCELL Morgan Stanley	11.5
92	PATRICIA RUSSO Lucent Technologies	12.4

Data: *Golf Digest*





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Up Front

CAR TALK

SMART—OR ROAD KILL FOR SUVs?

CAN EUROPE'S TINY SMART car make it in the land of the pickup truck and SUV? DaimlerChrysler hopes so. Smart cars have been nothing short



CITY SLICKER: A Smart car

of a sensation in European cities. Now Daimler is considering selling them stateside.

Hipsters in cities such as Los Angeles, Miami, and New York might pay \$15,000 or more for a Smart car, analysts

figure—nearly twice the European starting price. After all, at about 8-feet long, it's easy to park. And at 70 miles per gallon, it could catch on with the eco-crowd. "It's not a car for the Midwest, but the convertible would be nice in California," says Andreas Renschler, head of Mercedes-Benz's Smart division.

But the auto maker faces several challenges—among them, convincing Americans that a Smart won't be flattened if it has a run-in with an SUV. And for a U.S. launch to be profitable, Daimler would have to sell 8,000 Smart cars a year. That doesn't seem far-fetched, considering the success of the comparably priced Mini Cooper, BMW's rendition of the venerable—and tiny—British original: 7,000 of them have been sold since the U.S. launch in March. *Christine Tierney*

HAPPY RETURNS

PAINLESS PLASTIC FOR SHOPAHOLICS

FORGET DEBIT CARDS. FORGET credit cards. The two are merging into a new type of card that can help people who have trouble maintaining bank balances or making minimum payments on their credit cards. Nearly a dozen companies, including Reliance Insurance and Western Union, have issued the "Clear Card" as a benefit to about 1,500 employees since January. Another dozen companies are expected to begin offering it by fall.

How does it work? Buy an \$80 pair of pants, for example, and your next four paychecks will show deductions of \$20.

"The card is ideal for people who have had credit problems," says John Gregitis, senior vice-president of marketing at E-Duction, the company working with MasterCard to offer Clear Card. It looks like a regular MasterCard, and employees pay a \$29 annual fee. Their credit limit is 2.5% of their salaries, there's no interest charge, and automatic deductions mean the card always shows a clean credit history.

Companies say offering such benefits gives them a competitive edge. Notes Wendy Carver-Herbert, a spokeswoman for Western Union, where 10% of U.S. employees use Clear Card: "We're always looking for ways to bring in talent." *Andrew Heller*



DRAWN & QUARTERED



SECOND ACTS

WEB HITS OF A SALESMAN

SINCE WILLIAM H. MACY portrayed him in the TNT made-for-television movie *Door to Door*, Bill Porter still gets up at 8 o'clock every morning, makes himself breakfast, and schedules sales calls around reruns of *Matlock*. But for the 69-year-old salesman who, despite cerebral palsy has been selling home products for the Winona (Minn.)-based Watkins Inc. for almost 47 years, one thing has changed: He is unexpectedly on his way to becoming a rich man.

In just three days after *Door to Door* first aired on July 14, Porter's Web site, www.billporter.com, which of-

fers products ranging from organic dishwashing detergent to barbecue sauce, has pulled in \$60,000 in sales, according to Shelly Brady, Porter's longtime friend and business associate who was also portrayed in the movie. By comparison, Porter was

"Salesman of the Year" in 1989 for sales of \$42,460. His Web site has risen steadily from 80 percent in the days after broadcast to per second end of July. result: more

\$125,000 in gross sales for the month, 44 times more he makes in a usual month.

The first thing Porter plans to do with his newfound wealth? "Pay in taxes," he says. "Then build a new house. I'm getting old." *Andrew F.*

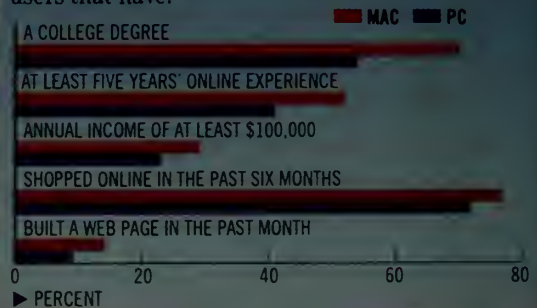


PAYOFF: Actor Macy

THE BIG PICTURE

THE ONLINE ELITE

While Mac users make up only 8% of online Americans, they're more educated, better paid, and more Internet-savvy than PC users. Below, the share of Mac and PC users that have:



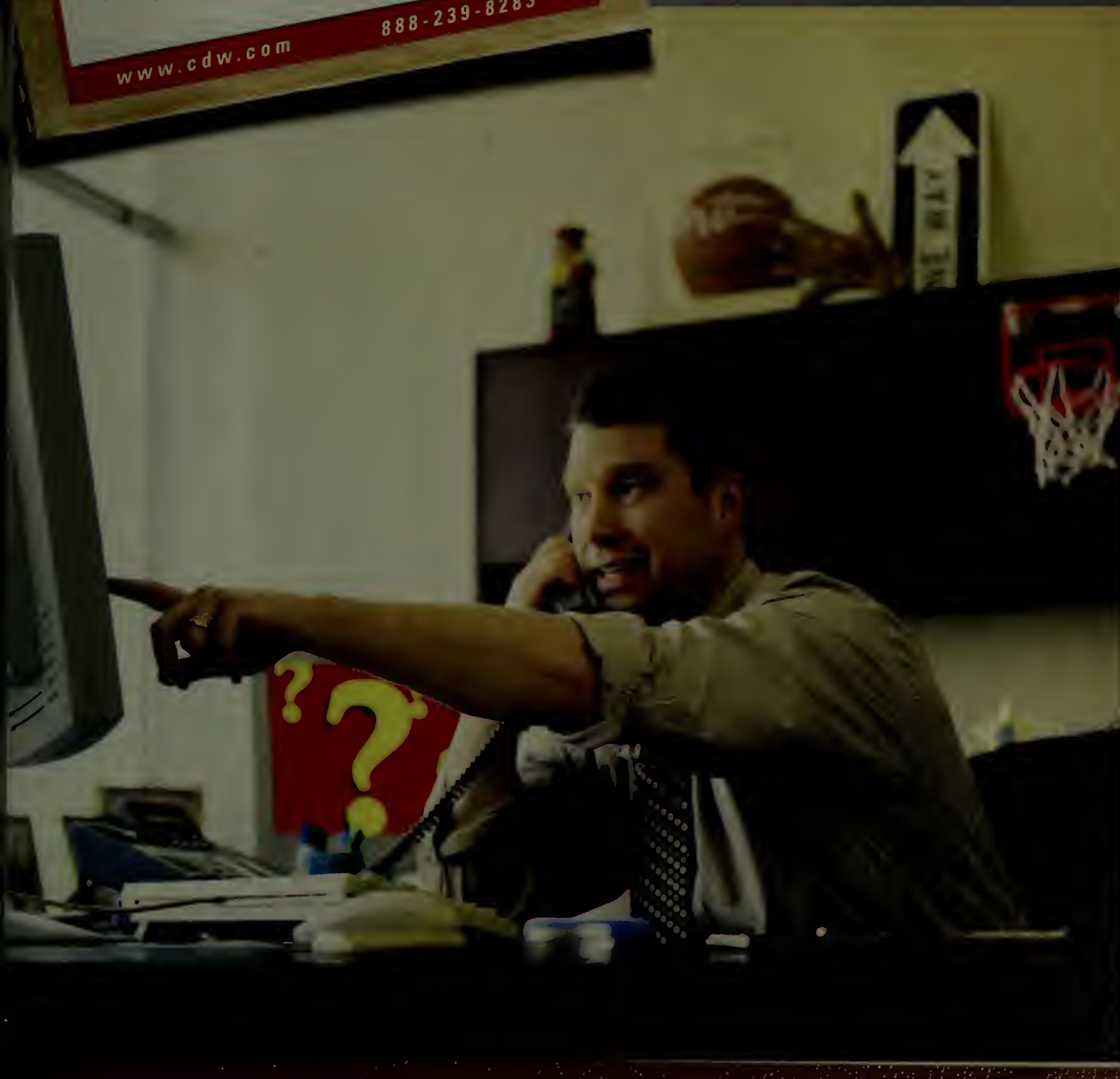
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Readers Report

INVESTORS GOT WHAT THEY DESERVED

The false prophecies advanced by respected analysts have come back to haunt the individual investor ("The angry market," Cover Story, July 29). Four assumptions have been proven incorrect, namely that stocks suddenly were risk-free, that their price would increase indefinitely, that elevated price-earnings ratios were acceptable because of the New Economy, and that dividends were unimportant. When stocks were properly valued at a Dow of 1700 in 1987, many individual investors refused to buy but did buy when it was grossly overvalued at 11,000 in 1999. The lessons: Markets will always correct in the long run, growth must be real, and dividends still have a role in the market as indicators of the financial health of the corporation.

Nelson Marans
 Silver Spring, Md.

I don't believe that we are in a bear market. I believe it is a correction from the "bull—" market that gave stocks idiotic valuations in the first place. During the past two decades, anyone who could say "buy" or "strong buy" could have been a market analyst. (They are still saying this all the way down, too.)

Of significance is the Private Securities Litigation Reform Act of 1995 under Newt Gingrich's Contract with America. This bill protected accountants and law firms from liability for publishing misleading financial results and had the effect of repealing the Glass-Steagall Act (created after the Crash of 1929, so it would never happen again). Both Republicans and Democrats pushed it over Bill Clinton's veto and dogged Securities & Exchange Commission Chairman Arthur Levitt Jr.

to not do his job. We investors got what we deserved.

Jim R. Chandler

A LESS OPTIMISTIC VIEW ON THE ECONOMY

In "The case for optimism" (S&P Report, July 29), Michael J. Mandel long-term trends as the basis for arguments for a stronger-than-expected economic recovery. I'm wondering are really just starting to feel the term impact of the September attacks. With a massive shift of focus into security and government spending budget deficits have come roaring. This feels like spending to stay in rather than spending to grow.

Although Mandel reports that real profits and productivity are real profits are coming from a slow wage growth resulting in eight the earnings growth. This expensive growth may be signaling that settling into a much slower growth period where price-earnings ratios of 15 times earnings may start to look expensive. If this becomes true, the expect a much longer decline in the market indexes. Consider that all talk about good economic indicators from a normal economic point of may not properly weigh whether thing is "normal" anymore.

Darryl D. Norwell, Jr.

DON'T TURN CEOs INTO ACCOUNTANTS

As a CEO of a small company, not against reforms trying to stop corporate corruption ("Getting the sage, finally," Editorials, July 29). ever, if we change the traits of

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Readers Report

CORRECTIONS & CLARIFICATIONS

"Can CalPERS afford to throw stones?" (Finance, June 24) stated that all California Public Employees' Retirement System board members voted on investments involving money managers Ronald Burkle and Richard Wollack, except for Kathleen Connell, who abstained, and Sidney L. Abrams, who was absent. In fact, other board members were absent for one or more of the three votes. However, at least 10 of the board's 13 members participated in each vote. All three votes passed without opposition.

CEOs, we will inadvertently change the performance of our corporations.

CEOs must be aggressive, innovative, and competitive and act with resolve and confidence. If you turn CEOs into accountants, signing and certifying their financial results, I bet most will focus on not making mistakes instead of leading the company. CEOs in large part have brought America tremendous wealth. During the business cycle of the 1990s, 99% of the productivity gains translated into \$809 billion that went to workers in the form of more jobs and higher compensation, as you say in "Restating the '90s" (Cover Story, Apr. 1).

Americans are angry now. But it's unwise and dangerous to act when you are angry. To remove the limited liabilities from the system could change the fundamentals of capitalism. Don't discourage the good CEOs, who in part will be the ones that we count on to generate the wealth of our society.

Tricia Liu
CEO
MediaChip Corp.
Parsippany, N.J.

SETTING THE RECORD STRAIGHT ON AVIALL

We at Aviall read "Cash-flow hocus-pocus" (BusinessWeek Investor, July 15) with deep dismay and indignation. Given today's environment of mounting public distrust of corporate reporting, we believe your implication that Aviall Inc. misrepresented its operating results was incorrect and unfair.

Your statement, Aviall "was able to take advantage of generally accepted accounting principles (GAAP) that allow overdrafts to be lumped into accounts payable" implies that we have a choice in this accounting treatment and exercised that choice to distort our cash flow intentionally. This is wholly incorrect,

as under GAAP, we have no choice to classify overdrafts as current liabilities. Furthermore, the operating cash reported in 2001 was primarily related to a large investment we made in a significant new product line in December 2001, that is enabling us to increase earnings substantially in 2002. Far from a "nasty surprise," this investment and similar investments in other new product lines were disclosed in press releases and in our form 10-K.

If you believe reporting in accordance with GAAP distorts the operating performance of a corporation, perhaps you should write an article discussing these issues. However, you should cease attempting to tar innocent corporations with the brush of accounting "hocus" for following the strict rules set out by authorities such as the Financial Accounting Standards Board and the Securities & Exchange Commission.

Also, Aviall is the leading independent parts distributor in the automotive market, not a "manufacturer" as stated in your article.

C. Van Den Hoven
Vice-President and Treasurer
Aviall Inc.

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BAMBOOZLED AT THE REVOLUTION

How Big Media Lost Billions in the Battle for the Internet

By John Motavalli

Viking • 334pp • \$26.95

THE SINKHOLE OF 'SYNERGY'

It's no secret how horribly the media industry bungled its foray into the world of the Internet, costing companies tens of billions and immeasurable amounts of shareholder trust. The failures are still making headlines: One by one, some of the most visible poster boys for so-called synergies between media and the Internet—Vivendi Universal CEO Jean-Marie Messier, AOL Time Warner Chief Operating Officer Robert Pittman, and Bertelsmann CEO Thomas Middelhoff—have been deleted from their jobs this summer.

The buzz created by these juicy ousters must seem like a promotional godsend to John Motavalli, author of *Bamboozled at the Revolution: How Big Media Lost Billions in the Battle for the Internet*. His book is a timely, if sometimes disjointed, chronicle of how, from 1993 to early 2002, one member of the media's Old Guard after another blew it in the Brave New World. "When companies try to do things they're not geared up to do, they mostly mess up," writes the former *New York Post* columnist who later worked at Internet incubator CMGI. "It's like a Volkswagen assembly line suddenly being asked to start building Cadillacs. They simply don't have a clue and the machines are configured wrong."

Bamboozled also casts a critical look at the media's Net coverage, making reference to several magazine cover stories, including some in *BusinessWeek*, that lionized execs who later took a fall. Motavalli completed his work in the spring, before the latest spate of news that includes the Securities & Exchange Commission and Justice Dept. accounting probe at AOL Time Warner Inc. Now, renewed questions about all the media companies' convergence strategies make *Bamboozled* compelling.

On the basis of scores of interviews, Motavalli considers the maneuvers of

several of the Big Media players, from News Corp.'s unsuccessful \$2 billion on-line partnership with phone company MCI Group to Walt Disney Co.'s failed Go Network, which led Disney to take a \$790 million non-cash charge in 2001. But *Bamboozled* focuses mostly on Time Warner Inc., whose January, 2001, sale to America Online Inc. is widely viewed as the biggest bust of all. AOL Time Warner's stock has plunged more than 70% since the merger closed, wiping out \$100 billion in market value. The merged entity failed to deliver the profit growth it had promised, in part because of the ongoing advertising drought but also thanks to AOL's flubbed broadband strategy. Adding to AOL's humiliation, Time Warner execs are once again running the show.

Motavalli begins his tale in 1993, when Time Warner CEO Gerald M. Levin was proclaiming that the future had arrived in the form of a new service in which Time Warner would invest \$5 billion, the Full Service Network. This high-tech system would allow Time Warner cable subscribers to use TV interactively, ordering movies or shopping. But the venture never took off, marking the first of several Time Warner new media debacles, including the failure to make the company's Pathfinder Web site a major portal. Those failures only heightened Levin's desperation for an Internet strategy. Fearful that AOL might make a deal elsewhere, he sold Time Warner to AOL at the peak of the tech bubble.

Motavalli has assembled a remarkable collection of anecdotes showing clueless media executives fumbling the ball in cyberspace while clashing with their Polo-shirt-wearing, entrepreneurial

counterparts. In one episode, which takes place shortly after the AOL takeover was announced in January, 2000, Warner CFO Richard J. Bressler (CFO at Viacom Inc.) asks David Colburn, AOL's president for business affairs, to explain pop-up ads. Can Colburn provide more information about them? At Bressler's lack of Net acumen, Colburn replies: "Rich, why don't you just invest \$21.95 in an AOL subscription and consider it due diligence."

Elsewhere, the author recounts a 1994 meeting that highlights the guys' arrogance. AOL had proposed a joint venture with Time Inc., but AOL Chairman Stephen M. Case just learned, Time Inc. New Media President Walter Isaacson had rebuffed the offer. "You know, you're probably right, but you know how to get subscribers better than us, you know how to program better than us," Case says sarcastically. "But if whatever you do

you will get the job as editor-in-chief of *Time* magazine." True enough, Isaacson had risked little and went on to be the managing editor at *Time* and then runs Cable News Network.

All such tales are of interest for media junkies and investors. But the level of detail may be too much for the average reader. And, often, the author will simply describe events, providing little interpretation. Finally,

it would have been instructive to include a chapter devoted to a media company that resisted the temptations of the Internet. Sony Corp., for example, refused to take the plunge. Today, its chief executive, Sir Howard Stringer, is having the last laugh.

In his conclusion, Motavalli anticipates a new pragmatism. He believes that trends favor the Web and electronic distribution of some types of content but that media companies will do well to return to their old way of doing business. Perhaps the lessons from the scary days of 1999 and 2000, along with the memory of the billions lost, will help Big Media avoid being bamboozled the next time around.

BY TOM LO

Media Editor Louwry covers AOL Time Warner from New York.



A TIMELY CHRONICLE OF HOW THE MEDIA'S OLD GUARD BLEW IT IN THE BRAVE NEW WORLD

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BY STEPHEN H. WILDSTROM

tech&you@businessweek.com

WIRELESS E-MAIL: A WORK-IN-PROGRESS



Three new devices combine voice phone, e-mail, and a PDA. They all need fine-tuning

Wireless phone companies are busy rolling out new, faster data networks that they hope will spur their slumping industry. And hardware makers, who could use a shot of growth themselves, are pumping out products for these networks that combine a voice phone, a personal digital assistant, and e-mail into a package that can easily be slipped into a pocket or purse. Both the devices and the networks have a ways to go, but the promise is tremendous.

I took a look at three devices—the BlackBerry 5810 from Research in Motion, the Handspring Treo 270, and the Pocket PC Phone Edition from T-Mobile (formerly Voice-Stream Wireless)—all of which run on GSM networks. This is the dominant technology in most of the world, and it's gaining fast in North America. It offers two flavors of data communications. The newer technology, called GPRS, promises a top transmission speed of 64 kilobits per second and, theoretically, an always-on connection to the Internet that eliminates the need to dial in every time you want to fetch data.

The T-Mobile handheld (\$549 with activation) is, along with the virtually identical XDA sold by wireless carrier mmO₂ in Europe, the first product to use Microsoft's new Pocket PC phone software. It does a good job of integrating the phone with the device's other functions. Not only can you easily call any number in your contact list, but you can initiate a call by clicking on a phone number in an e-mail message.

If you have a GPRS data account (\$19.95 to \$59.95 per month in addition to a voice account), you can use the Pocket PC e-mail program to connect wirelessly to any standard Internet e-mail account. It can handle Microsoft Word and other common attachment types. To get my corporate e-mail, I used Infowave's Symmetry Pro, which delivers Microsoft Exchange mail from your desktop. But it costs \$19.95 a month, on top of the other charges.

I found, however, that GPRS fell well short of its promise. The Pocket PC had to establish a

network connection each time it needed to or receive data, a process that took as long as dialing a call and logging in. It's hard to measure network speed in e-mail transfers, but mine was considerably slower than a wired connection. And there were times when the work was simply unavailable, even in Washington, D.C., where voice service is normally available.

The hardware could also stand some improvement. I now believe that a keyboard, however small, is a requirement for e-mail. I found even the choice of a couple of styles of writing input and an on-screen keyboard a poor substitute for real keys. In phone mode,

Pocket PC is not well-designed for one-handed operation. A scroll wheel that allows you to move easily through lists would be a big improvement.

The BlackBerry 5810 from T-Mobile plus \$39.99 a month for e-mail with a plan) looks and functions very much like the older BlackBerry 5810 and 857, which run on GSM networks. All GSM devices have voice capability, but the BlackBerry has a clunky interface and can be used as a headsets.

T-MOBILE

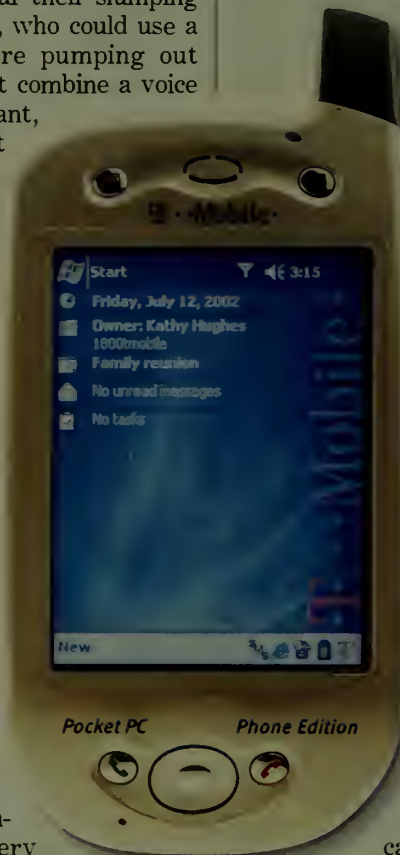
A scroll-wheel for negotiating phone lists would help rate very

for use in North America the rest of the world was fixed in a model due to year-end.) The 5810 has worse network coverage, much shorter battery life, and cause mail comes in automatically while the BlackBerry is in your

et or purse, you never notice the higher speed. The BlackBerry is a great way to corporate e-mail on a wireless device, but stick with the older versions.

The Treo 270 (\$499 with service) adds a color screen and lit keys to the Treo 180 (Tech & You, Apr. 29). Although it uses older wireless data technology, it was more reliable than GPRS and didn't seem that much slower. Treo Mail service for getting corporate e-mail costs \$99.99 per year plus air time, and it requires an Internet access account. The Treo offers the best melding of PDA, phone, and functions and it boasts the easiest-to-use device.

Right now, all of these devices are better than the networks they run on. But those networks are getting better, and there are versions in the works for the new Verizon Wireless and Sprint PCS data networks. Within six months or so, wireless e-mail may really be ready for the business mainstream.

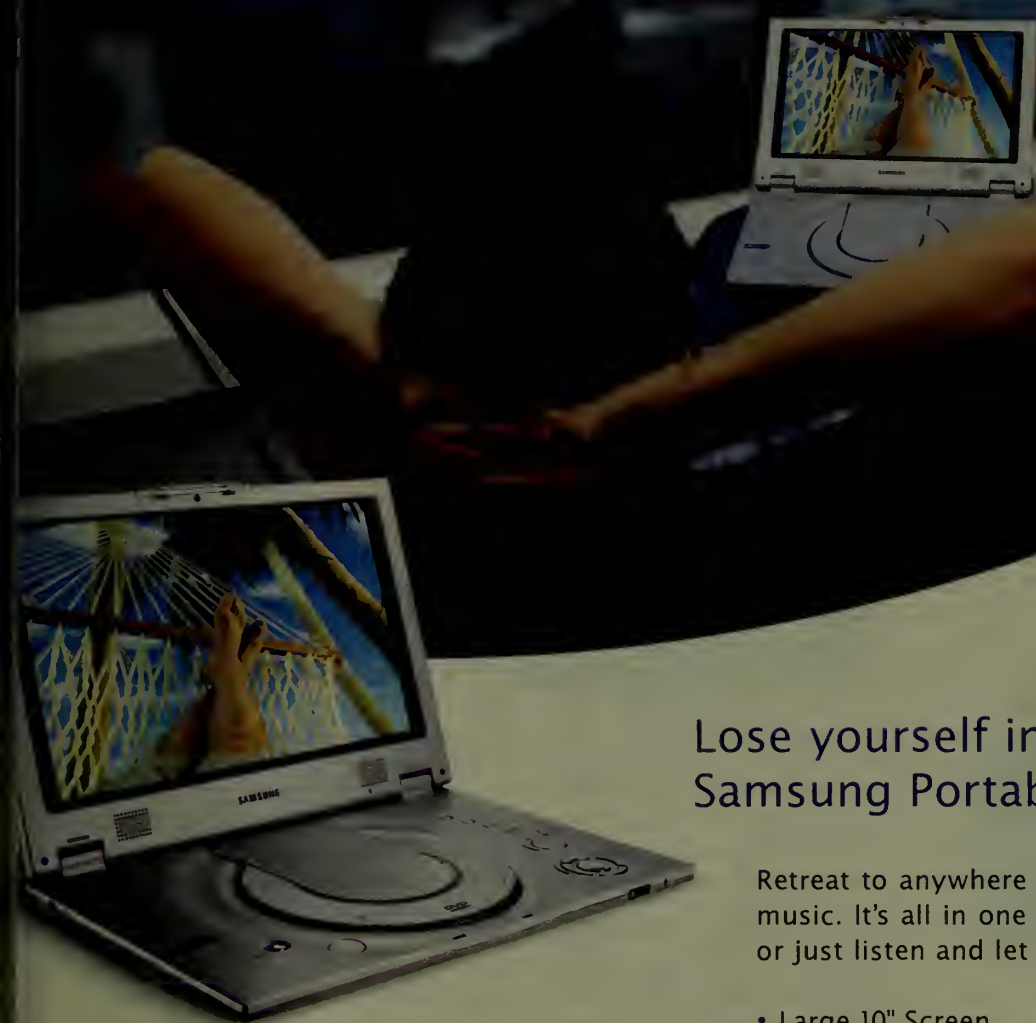


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BY ROBERT J. BARRO

BUSH'S ECONOMICS TEAM IS BROKEN, AND IT'S TIME TO FIX IT



MUDDLED:
The White House economic policy comes up short. Taking a longer view would help, and new advisers wouldn't hurt

Robert J. Barro is a professor of economics at Harvard University and a senior fellow of the Hoover Institution (rjbweek@harvard.edu).

When it comes to advice and expertise, the Administration's economic chiefs are no match for its international security leaders. Basically, O'Neill-Lindsey is no Rumsfeld-Cheney. Paul O'Neill is candid and undoubtedly made a strong CEO, but he lacks the financial and economic skills needed for being Treasury Secretary. Lawrence Lindsey, Assistant to the President for Economic Policy, never was a strong economist, and I was always concerned by the President's reliance on him.

I have to admit that I once wrote a column stating that economic outcomes bore no relation to the credentials of an Administration's main economic advisers. But this proposition is now being severely tested, and a cautious approach would dictate a change in the top personnel. Even within the Administration there are strong candidates, such as R. Glenn Hubbard, chairman of the President's Council of Economic Advisers, and John Taylor, under secretary of the Treasury for international affairs.

Since the mostly laudable tax cut, the Administration's economic policies have been pretty bad. Most glaring is the protectionist stance on international trade. Steel tariffs, lavish farm subsidies, and duties on Canadian timber indicate that short-term political gains have been favored over national economic benefits. Remarkably, the Administration now is following up on this protectionism by pursuing free-trade agreements—a dubious strategy after the destruction of our free-trade credentials.

The Administration also has lacked fiscal discipline on the spending side. For example, Bush pushed for an extravagant bill on education. On Medicare, the Administration has adopted the agenda of its opponents by debating the form of a new program for prescription drugs, rather than seeking a decrease in overall spending. The President created a new Cabinet department for homeland security, continuing the process of enlarging the federal government. A better approach would have been to eliminate departments, such as education and transportation. The spending strategy seems to be to predict the Democratic position and then get out in front by taking this position first.

The White House also has accepted the Democrats' reaction to the corporate scandals by signing the Sarbanes/Oxley Act of 2002. This legislation seems largely innocuous, but it would have done nothing to lessen the financial problems that many high-tech firms have experienced. Consider WorldCom Inc. and its inappro-

priate booking of \$3.8 billion of current expenses as capital outlays. A more accurate picture of earnings would have resulted in an earlier drop in the stock price and an earlier bankruptcy. Mostly the same people would have lost the same amount of money. The main problem is that WorldCom vastly overinvested in a telecom network that now is worth a fraction of its cost. This miscalculation, and not accounting tricks or corporate greed, is the main reason for its financial collapse. Anyway, corporate failure is a constant; it was not discovered in 2002.

If one wants to consider a government policy that actually mattered for WorldCom, then one can go back to the rejection of the merger between WorldCom and Sprint in June, 2000, by the European Union and the U.S. Justice Dept. It is laughable in hindsight that the two governments were concerned about the potential negative consequences of the merger for competition in Internet-based services and long-distance telephony. Instead, with the dramatic excess in telecom capital, the prices that providers can command are too low to sustain profitability. Presumably, to the government officials would be happy if Sprint and AT&T—which themselves are in tenuous financial states—were to absorb WorldCom. Actually, it might be good economic policy if the European and U.S. antitrust divisions went out of business.

One can take a quantitative approach to assessing the economic outcomes that result from an Administration's economic policies (together with many factors beyond the government's control that have written before about an extended "misery index" that considers inflation, unemployment, interest rates, and gross domestic product growth. For the Bush Administration, through the second quarter of 2002, inflation has been low (1.9% rate, compared with 3.7% at the end of the previous Administration); unemployment has done poorly (an average rate of 5.1%, compared with 4.2%); interest rates have been low (4.7% on 20-year U.S. Treasury bonds, compared with 5%); and economic growth has been weak (1% rate, compared with a long-term average of 3.1%). Putting all this together, the Administration thus far ranks 8th out of 14 Administrations since Harry S. Truman's second term. Bill Clinton comes out just behind his father.

Clearly, the Administration needs to do more to improve its economic policies. A change in the top advisers may help. But, more to the point, the Administration must rely more on sound economic principles and less on short-term political maneuvering.

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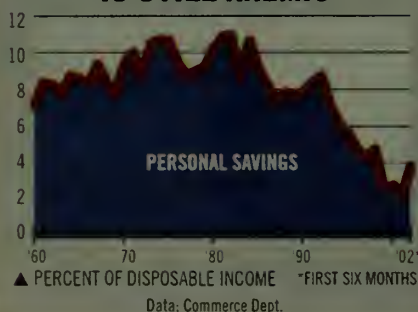
BY GENE KORETZ

LESS GOLD IN THE GOLDEN YEARS?

Boomers need to get frugal

Remember the personal savings rate? When it tanked in the 1990s, many economists decided its decline didn't matter because household financial assets were soaring. The rising stock market, they claimed, was painlessly doing the retirement saving for free-spending baby boomers.

HOUSEHOLD SAVING IS STILL ANEMIC



Fast-forward to 2002. Collapsing stock prices have sapped household net worth. For many Americans, the dream of a carefree retirement has evaporated. And economists are eyeing the anemic savings rate with renewed concern.

Even without Wall Street's woes, it's becoming clear that a majority of middle-aged folks may face greater financial pressures in retirement than their parents did. Many upper- and middle-class workers were mauled by the market decline, but the retirement prospects of far more families have been hurt by changes in the Social Security and private pension systems. (In 1998, the bottom 90% of households accounted for just 18% of stock market wealth.)

Back in 1983, Congress lowered future Social Security benefits by increasing the "full retirement age" at which people would become eligible for full Social Security checks, which had been 65. However, the legislation mandated that the increase would take effect only with people born in 1938 and after—that is, folks approaching retirement today. Thus, if you were born in 1938, your full retirement age is 65 years and two months, and the age for full benefits will keep rising over the next two decades until it reaches 67 for people born in 1960 or later.

This process translates into growing benefit cuts for people who choose not to defer retirement. Next year, for example, people who apply for Social Security when they turn 65 will receive 1.1% less than they would have gotten under the old formula. By 2008, such applicants will get 6.2% less, and the cuts will hit 12% when the full retirement age reaches 67. Meanwhile, those who opt to collect reduced benefits early, at age 62, will suffer a larger cut.

The fact that these cuts were enacted to bolster Social Security's financial health doesn't lessen their impact on older folks' budgets. Today's seniors may be the wealthiest in history, but two-thirds of those over 65 still rely on their Social Security checks for at least half of their income. Moreover, while retirement ages have edged up in recent years, the average is still under 65.

Meanwhile, the rapid growth of 401(k) defined-contribution pension plans in place of traditional defined-benefit plans seems to have helped fewer families than commonly believed. While 401(k) assets exploded in the 1980s and 1990s (and have since imploded), the increase was concentrated among more affluent families. Economist Edward N. Wolff of New York University estimates that the real pension wealth of two-thirds of households headed by someone 47 to 64 was no higher in 1998 than in 1983.

One reason may be that lower-wage workers tend to contribute less of their pay to 401(k)s than higher-income workers—and often liquidate them early. Although two-thirds of 401(k) assets are rolled over into new plans when workers leave an employer, notes economist Alicia H. Munnell of Boston College's Center for Retirement Research, two-thirds of workers with 401(k) accounts cash them in when changing jobs.

The market collapse underscores the need for policymakers to find more ways to encourage thrift, and the savings rate has finally begun to rise. But it will have to rise a lot more if the baby boomers are to realize their retirement dreams.

A NEW CEO IS NO SAVIOR

Quick turnarounds are a myth

In recent years, more investors and corporate boards have bought the notion that an effective cure for lagging company performance is to get rid of the CEO and bring in a highly regarded replacement. As a study to be present-

ed at the Academy of Management annual meeting this month indicates, however, it was never quite that simple.

In the study, Margarethe F. Wiersma of the University of California at Irvine analyzed CEO successions in a group of 500 major companies in 1996 and 1997. Of the 83 that made changes at the top, 37% involved dismissals. But such drastic action generally failed to foster a recovery in company fortunes. Using a number of performance measures, Wiersma found no evidence that companies did better in the two years following dismissals. Indeed, judging by stock prices, they usually did much worse.

Wiersma concludes that corporate woes leading to a CEO dismissal usually take many years to correct. Boards seeking a "savior" CEO were probably showing deferential to the past CEO. And a turnaround may prove elusive unless board members start exercising oversight of the new chief.

WHEN A TAX HIKE IS GOOD NEWS

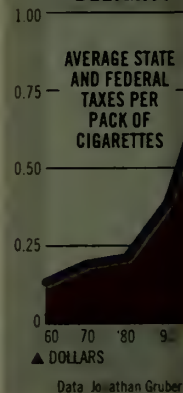
Smokers may feel it helps them

That some taxpayers might welcome new taxes seems an economically dubious notion. Yet that is precisely what Jonathan Gruber and Sendhil K. Lahiri of Massachusetts Institute of Technology found in a study of smokers' reaction to cigarette taxes.

Most smokers say they want to quit but find it hard to do so. Since studies show that rising tobacco prices discourage some folks to stop, the two economists figured their ultimate reaction to tax hikes might actually be positive.

To find out, they analyzed U.S. and Canadian survey data of people's reactions to their own happiness to see if they were affected by growing state and federal cigarette taxes. In fact, they did find that well-being in groups prone to smoke rose significantly in the wake of tobacco tax hikes—but not beer or alcohol tax rises. "The tax hikes," says Gruber, "apparently made many smokers happier by helping them to stop or reduce their smoking."

SMOKERS DELIGHT?



AMES C. COOPER & KATHLEEN MADIGAN

CORPORATE AMERICA: DEER IN THE HEADLIGHTS

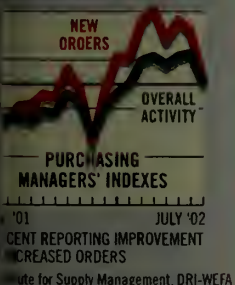
How long will it be transfixed by scandals and the stock slide?

U.S. ECONOMY

The market plunge this summer is weighing on Corporate America. Companies seem to be frozen, waiting to see how much damage, if any, has been done to the recovery. This tendency to pause during a shock is classic stress behavior, but it also cuts into economic growth, posing a new question for the outlook: When will business shake off its uncertainty and move forward with confidence into the future?

A big danger is that the stock market and the economy will feed off each other in a way that could hurt recovery. Bear in mind that for several months, investors ignored the good economic news, focusing instead on corporate crime. The irony now is that investors are paying more attention to the economy—but as new reports suggest that prospects for the second half are taking a turn for the worse.

INDUSTRIAL ACTIVITY HITS AN AIR POCKET



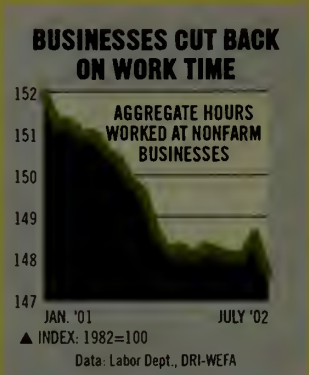
The wave of corruption scandals means that businesses have expended a lot of time and resources addressing new accounting and governance issues. Planning has suffered, borrowing is down as lenders demand higher-risk premiums and companies table new projects, and equity financing has been crimped by weaker stock prices. This corporate vacillation is beginning to affect the economic data (charts). Hiring has slowed, companies are trimming the hours worked by their employees, and a few are actually furloughing some of their temporary workers. Economists are showing new caution, too. For example, forecasters at J.P. Morgan Chase & Co., who were expecting 4% growth in the second half, have cut their projection to 2.75%. Economists whose numbers were already in the range of 2.5% to 3% are saying, "We told you so." And the double-dippers, who see a second round of stagnation or outright recession, are speaking bolder, although their ranks are still thin.

BE SURE, the events of this bear-market summer will be felt in the economy during the second half, but how much? Businesses may choose not to replace worn-out equipment or expand. Many will be hesitant to add to new inventories; some will wait before extending their payrolls. And on the consumer side, some

households will choose to save more and spend less.

These patterns are already evident. In June, new orders took a nosedive, including bookings for capital goods. The nation's purchasing managers said the order slowdown continued in July. The Institute for Supply Management's index of industrial activity dropped from 56.2% in June to 50.5% in July, the steepest decline since just after September 11.

Then came the July employment report. Payrolls posted essentially no growth last month, and the jobless rate held at 5.9%. Those numbers weren't out of line with the recent pattern of labor-market stabilization. What was new, however, was an 18-minute plunge in the overall workweek, to 34 hours—the sharpest fall since early 1996, when a blizzard hit the East Coast.



A steep 24-minute decline in the factory workweek, after a steady rise since November, along with a cut-back in plant overtime, was especially disconcerting for the outlook. Remember, the factory-sector cutbacks in late 2000 were the best indicator of the economy's coming weakness, and the sector's upturn in late 2001 was an important signal of the recovery.

Few businesses actually made significant cuts in their payrolls in July, but temp agencies did see a big drop—of 35,000 jobs—after four consecutive months of increases. Falling temp jobs in 2000 foreshadowed the broader 2001 payroll losses, and their upturn this year had been a good omen for overall payrolls later on.

BUT AT THE SAME TIME, demand by both consumers and businesses remains strongly supported by low interest rates, generous tax breaks, solid income growth, a more competitive dollar, rising productivity, and a rebound in profits.

Consumers, in particular, show few signs of flagging. Retailers noted a certain amount of sluggishness in July, but nothing ominous. And car dealers received a rousing response to their 0% financing deals. Cars and light trucks sold at an annual rate of 18.1 million vehicles in July, the second-strongest month on record, up from 16.5 million in June and 15.7 million in May. Auto makers are already boosting their third-quarter pro-

Business Outlook

duction plans in order to replenish inventories.

Consumers are still buying houses and refinancing existing mortgages, according to the trends in loan applications. Because of falling mortgage rates, refi activity in late July was approaching the record levels seen last year. Cash-outs and lower payments will put additional money in shoppers' wallets.

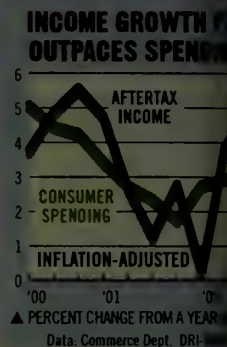
In addition, household real income, after taxes and inflation, has grown 5% during the past year. Tax breaks and falling inflation have offset labor-market weakness. In fact, real income is growing well faster than the 3.1% pace of real consumer spending (chart). That means consumers have been able to lift their savings rate from 1.9% of income a year ago to 4% in the second quarter. Consumers have been able to add to their cushion and still spend at a healthy clip.

THE CURRENT JUMBLE of opposing trends—solid demand but no strong pickup in jobs—stems partly from the nature of this business cycle. In other words, mild recoveries tend to follow mild recessions. Add in the corporate scandals and their impact on the market, and it's easy to see why businesses and investors perceive this recovery as weak relative to past upturns and especially when compared to the boom conditions prior to the recession. The fact is, economic growth over the past three quarters has averaged almost 3%. Few would complain about this growth rate during an

expansion, but in this recovery, it is considered feeble. Erroneous or not, this perception of subpar growth is prompting the credit markets to believe the Fed's next move will be to cut interest rates. Officials themselves downplay that prospect, but they admit that the balance of risks in the outlook is slightly more tilted toward weakness than strength.

Policymakers will decide whether to adopt that stance formally when they meet on Aug. 13, although almost no one expects a rate cut at the meeting. Fed watchers, however, are pushing their expectations of the next hike further into the future, and that outlook is encouraging market rates to move lower. So overall financial conditions are actually easing without the Fed's lifting a finger.

In a nutshell, the risks in the outlook have increased and that's why so many companies are holding their breath. But solid economic fundamentals are still supporting growth, and excesses in capacity and inventories have already been pared away. That means businesses should soon be able to breathe a sign of relief. The signs in coming months confirm that a moderate recovery remains in place.



URUGUAY

A BRIGHT LATIN BEACON IS SNUFFED OUT

Uruguay has been called the Switzerland of Latin America: a stronghold of financial stability in an often chaotic region. Today, however, it is a case study in contagion—the victim of its reckless neighbor across the Rio de la Plata, Argentina.

The warm waters of Uruguay's beaches and its generous tax and banking secrecy laws have long been a magnet for rich Argentines in times of crisis. Foreign investors were attracted to the country's investment-grade status—the only Latin country besides Mexico to enjoy that rank. So Uruguayan assets became an anchor for many Latin American portfolios.

But the impressive track record

came to an end in January, when Argentina devalued and defaulted. That country's strict capital controls forced Argentines to dip into their Uruguayan savings, reducing those deposits by 80% since then. In June, Uruguay floated its peso, which promptly fell by 45%. Panicky investors pushed the country's banks to the brink of collapse, and bouts of looting occurred. After the bank run, the central bank on June 29 ordered a four-day bank

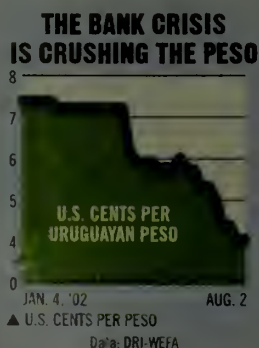
holiday, its first in 70 years. And the congress swiftly passed legislation exchanging \$2.2 billion in fixed-term dollar deposits for government bonds.

Responding to the government's

proactive stance, the U.S. made Uruguay a direct loan of \$1.5 billion as a bridge until the International Monetary Fund approves its own aid package. Although IMF should stem the deposit outflow, nobody can guarantee for how long, and the country's benchmark bonds still trade at default levels.

Although international banks have small exposure in Uruguay—\$7.7 billion in March, 2002, vs. \$50 billion in Argentina—the country's rapid demise portends a grim future for the region. The two bright spots left in Latin America, Chile and Mexico, are still little affected by the crisis in the Southern Cone. But the near-collapse of one stalwart economy shows that no nation is safe from the turmoil.

By Joshua Goodman
in Buenos Aires



A black and white photograph of four business professionals (two men and two women) in business attire walking down a modern office hallway. The man in the center is slightly ahead of the others, looking directly at the camera. The woman to his left is also looking forward. The woman to his right is looking down at a small object in her hand. The man on the far right is looking towards the camera. The hallway has a high ceiling with recessed lighting and glass partitions on the sides.

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MERGERS & ACQUISITIONS

GOING FISHING

With companies so cheap, buyers are again seeking strategic assets

In recent weeks, there has been a flurry of high-profile acquisitions. Warren E. Buffett snapped up distressed assets in the energy sector. Texas Pacific Group, a takeover giant, announced it was leading the acquisition of Burger King. Then, a deal that caught everyone's attention: IBM's July 30 announcement that it would buy PwC Consulting for \$3.5 billion. Gregory D. Brenneman, the man PricewaterhouseCoopers brought in to sell its consulting arm, says the time was right—for both IBM and PwC. In the 1990s, "clearly you had some major-league dope smoking, [with] multiples you just couldn't explain," he says. Now, "market values are coming down to reality."

As a result, the bottom-fishers are starting to troll. Cash-rich companies such as IBM are looking to plug holes in their businesses. Private equity firms, many of which have sat on the sidelines for the past 18 months, seem to be gearing up for action, too. Morgan Stanley estimates that such outfits have \$125 billion at their disposal and some are beginning to spend it. Beaten-down stock prices also have some companies, such as Charter Communications, pondering whether they would be better off taking themselves private—and off the market. "The field is wide open," says Stephen A. Schwarzman, president and CEO of the Blackstone Group, an investment bank with \$14.5 billion for private-equity investments.

To be sure, no one is predicting a full-fledged rebound in mergers and acquisitions—certainly nothing close to the frenzied levels of 2000. In all, some 3,849 U.S. companies have announced M&A deals this year, worth \$296 billion, according to Thomson Financial/First Call. By comparison, there were some 5,048 deals announced, worth \$497 billion, in the same period last year, and far more

in 2000. "There's a steady, though diminished, flow of deals," says Levy, co-chairman of M&A at Gol Sachs & Co. in New York. "It is means an avalanche, and there prospect of that happening soon."

Indeed, it is not yet clear whether the current round of dealmaking legs. With the economy failing, corporate executives and leveraged out chieftains are taking a wait-and-see attitude. Even those who have the plunge say they aren't sure the economy and the market for corporate assets have hit bottom. In the previous environment, says Jim Coulter, a partner at Texas Pacific, would-be buyers require "intestinal fortitude."

Still, the conditions have improved enough that many are willing to take a look for the first time in a while. For starters, sellers have finally gotten about what their companies will fetch. In the past 18 months, Francisco-based, the nation's largest tech-focused buyout firm, didn't even bother shopping. Not anymore. Thanks to reasonable prices, Francisco has three deals in the past month, including



\$800 million for General Electric's electronic-data division. With prices coming back down to earth, some companies are gambling that buying strategic assets will put them in a good position if the economy bounces next year. IBM is a case in point. The PwC Consulting deal made sense at \$18 billion, the price in late 2000. But it's a golden opportunity for IBM at the current cash-on-the-stock price. Such "bolt-on" deals aimed at filling holes in a company's businesses, a far cry from the high-at-any-cost takeovers that were the hallmark of, say, Tyco International and WorldCom Inc. in the late

90s in the battered telecom sector, which companies think things may have fallen far enough to begin snapping up distressed assets. Level 3 Communications Inc., shored up with a \$500 million investment from Buffett and others, has been bottom-fishing. Earlier this year, CEO James Q. Crowe paid \$200 million for two software companies that will attract new customers interested in digital delivery of software. Now, Level 3 is getting into buying network units of such recent competitors as WorldCom and E-Comm Inc. on the cheap. It's also eyeing the pipelines of such distressed telecommunications companies as Qwest Communications International Inc. and Genuity Inc., according to Grover, a telecom analyst at Kaufman Brothers LP.

For private equity firms, the calculations are somewhat different from the ones used at their corporate counterparts. While the likes of Kohlberg Kravis Roberts & Co. and Bain Capital have amassed massive war chests, they have had to be more careful for the most part to tread carefully. These firms are not looking for cheap assets to fill holes as much as

cheap companies they can restructure and sell at a profit. That means the price must be sufficiently low.

Some buyout firms—even those attached to publicly traded banks—have begun to pounce on distressed assets. One Equity Partners, which manages \$3.5 billion in capital for Bank One Corp., has been on a tear lately, for example. It paid just \$255 million on July 31 to help buy Polaroid Corp. out of bankruptcy, a price so low that Derek Jarrett, a former vice-president for international operations at Polaroid, says he was "horrified" at the sale. One Equity Partners, trolling for more such bargains, declined to comment.

Still, many of these firms believe the bottom is a ways off. Even if the economy improves, many analysts figure the big private equity firms won't plunge in until next year. "It's a difficult market because of a fundamental lack of confidence," says John R. Willis, managing partner at Willis Stein & Partners, a \$3 billion leveraged buyout firm in Chicago.

Indeed, the question now is whether the flurry of deals will keep gathering speed. Even if asset prices continue to soften, other factors could make it tough to complete some deals. In the troubled telecom and energy sectors, worries over accounting, regulatory challenges, and the possibility that legal liabilities would be transferred to new owners are casting a pall over the sale of assets. Just ask Qwest. The company is desperate to sell its \$1.6 billion-a-year Yellow Pages unit to help it pare back \$26.5 billion in debt. But ever since Qwest revealed that the sale would require regulatory approval in four states, buyers have melted away.

At the same time, the failure of acquisition

-fueled growth strategies of such '90s players as Tyco and WorldCom have made many execs queasy. "Today, you get whacked on Wall Street if you announce a large acquisition," says Mark A. Ernst, CEO of H&R Block Inc., which is adopting the "lower-risk proposition" of buying back its own shares. Indeed, Gregg Polle, managing director and co-head of the M&A Group at Salomon Smith Barney, argues that "company-defining" deals will be avoided until their stock prices rise and until target companies get through the next audit cycle, perhaps by next spring.

Still, for those with cash, the moment to go shopping may be approaching. "This is a terrific time to have liquidity," says Rodney L. Goldstein, managing partner of the \$600 million Frontenac Co. equity firm in Chicago. "In the third and fourth quarters, we're going to see a material upturn in acquisition activity." Nestlé certainly thinks the time is ripe. On Aug. 6, it announced it would buy Chef America Inc., maker of Hot Pockets frozen sandwiches, for \$2.7 billion. Like IBM, Nestlé clearly felt this was an opportunity it couldn't pass up.

By Joseph Weber in Chicago, with Emily Thornton in New York, Linda Himmelstein and Jim Kerstetter in San Mateo, Calif., Wendy Zellner in Dallas, Roger O. Crockett in Chicago, and bureau reports

WHY A FEW ANGLERS ARE STARTING TO TROLL

BARGAINS GALORE

Heavily indebted or otherwise weak companies are accepting reality: With prices unlikely to get stronger anytime soon, many sellers will take what they can get for their assets

EAGERNESS TO PLUG THE HOLES

Although the days of supercharged growth through acquisition are over, strong companies are eyeing distressed rivals to fill gaps in their core businesses

A BOTTOM COMING INTO VIEW?

Betting that the economy and markets will recover next year, some execs figure it's time to buy companies while they're still cheap

PLENTY OF MONEY IN THE WINGS

Private equity firms, which have raised a combined war chest of more than \$125 billion in the past year or so, are eager to deploy their cash



ENERGY

THE SAGE SEIZES ON ENERGY'S DISTRESS

Warren Buffett is scooping up prime assets at a discount

When Warren E. Buffett acquired MidAmerican Energy Holdings Co. in late 1999, Wall Street snickered. At the time, investors were enthralled with New Economy stars like Enron Corp., which had glamorized the energy business by reinventing itself as an "asset-light" deregulated trading company. MidAmerican was the Old Economy epitomized, a boring electric and gas utility—based in Iowa, no less. Buffett, the famously technophobic chairman and CEO of Berkshire Hathaway Inc., just didn't get it, various bull market savants scoffed. He was history.

What a difference a bear market makes. Today, Enron is bankrupt, and Buffett's \$1.24 billion purchase of a 76% stake in privately held MidAmerican—a deal that marked Berkshire's entry into energy—looks prescient. And now, the solidly profitable MidAmerican is capitalizing on the sector's distress by scooping up prime assets at a discount from beleaguered energy merchants and traders. On July 29, Dynegy Inc. agreed to sell its Northern Natural Gas pipeline to MidAmerican for \$1.9 billion. The deal, which should close by the end of August, followed on the heels of MidAmerican's \$956 million purchase of a pipeline from Williams Cos. in Tulsa. And on Aug. 1, Berkshire itself got into the act, loaning Williams \$450 million as part of an emergency restructuring.

Buffett's energy-industry dealmaking is likely to continue and could even increase in coming months. He is drawn to businesses that reliably throw off a lot of cash, and both utilities and gas transport fit the bill. With more than \$30 billion in Berkshire's coffers, America's premier value investor can well af-

ford to continue his bargain shopping in the energy patch as the selling continues. "The bow is tightening, and pressure from credit agencies and investors will lead to more quality asset sales," says President Jeff Gildersleeve of Argus Research in New York.

Buffett said last year that he was prepared to sink an additional \$10 billion to \$15 billion into the electric utility industry if Congress repealed the Public Utility Company Holding Act (PUHCA), which effectively prevents a company from owning more than one regulated utility. Capitol Hill insiders say that the final version of the energy bill now making its way through Congress likely will do just that. On Aug. 6, Buffett told *BusinessWeek* that he is still willing to invest as much as \$15 billion "for the right opportunity."

Buffett says that Berkshire might buy minority stakes in utility companies, but that any acquisitions would be made through MidAmerican, which post-

ed pretax income of \$398 million on revenues of \$5.3 billion in 2001. In the future, Buffett will continue to look to David Sokol, MidAmerican's 45-year-old chairman and CEO, for acquisition ideas. Sokol, a former Peter Kiewit Sons' executive, became CEO of a predecessor company to MidAmerican in 1997. "I would say that valuations in the utility sector are more reasonable right now than at any time in the past 10 years," says Sokol, who often works out of his office in Omaha right across the street from Berkshire headquarters.

Analysts say that MidAmerican is likely to face increasing competition from Duke Energy, American Electric Power, TXU, and other energy companies picking up their own bargain-hunting. But the depth of Buffett's pockets and the speed of MidAmerican's decision-making will be easily matched. "The great thing about those guys is that they make their minds," says Hugh McGee, head of Lehman Bros.' energy and power banking group. "It's awesome how quickly they can make a decision."

But even Buffett sometimes changes his mind. When MidAmerican bought the pipeline from Williams Cos. in March, it paid \$275 million of preferred stock convertible into about 4% of Williams common stock. Sokol says that the American investment in the pipeline stock was not a quid pro quo for the pipeline. "It was to separate," he insists.

In any event, by the time MidAmerican was looking at a \$275 million wipeout as Williams ran short of the cash needed to make an \$1.1 billion interest payment. With Lehman's help, Williams was able to avoid default—and likely bankruptcy—by selling \$1 billion in assets and borrowing \$900 million. \$450 million of it from Berkshire Hathaway.

If Williams remains solvent, Buffett may well be able to turn this mishap to his advantage. Williams is expected to sell yet another pipeline soon, and a safe bet that Buffett and Sokol will be at the head of the line of potential buyers.

By Anthony Bianco
with Emily Thornton
New York

BUFFETT'S PLAY-BY-PLAY

OCTOBER, 1999 Led a \$9.1 billion buyout of MidAmerican Energy, an electricity retailer and power generator that now forms the backbone of his energy empire. Buffett's equity stake was worth \$1.24 billion.

MARCH, 2002 Bought Kern River Gas Transmission—which added 926 miles of gas pipelines in the Western U.S. to MidAmerican—for \$956 million.

JULY, 2002 Paid Houston energy trader Dynegy Inc. \$1.9 billion for Northern Natural Gas, adding another 16,600 miles of Midwestern gas pipelines.

JULY, 2002 Loaned ailing Williams \$450 million, secured by oil and gas assets.

Data, *BusinessWeek*,
Bloomberg Financial
Markets

**THE CREDIT
SQUEEZE WILL
LEAD TO MORE
PIPELINE SALES**



NOT DONE LOOKING



By Laura Cohn

THE CASE AGAINST A RATE CUT NOW

During the U.S. economy's slide into recession and more recently, as confidence has been battered by corporate scandals and swooning stocks, Alan Greenspan has been a force of calm amid the chaos. But now, the Federal Reserve chairman finds himself in a touchy spot: With signs of a double-dip recession growing,

he's being urged to back up his soothing sermons and give the economy a boost by cutting rates again. The loudest cries for lower interest rates come from Wall Street, where fears are rampant that the expansion is losing steam. That view was bolstered by a jarring July employment report that showed virtually no job growth, with both services and manufacturing stalling. Soon afterward, analysts at Goldman Sachs predicted that the federal funds rate might fall to as low as 1.5% by the end of

the year. Currently, the funds rate sits at 1.75%, the lowest in 41 years. Goldman is hardly alone. Indeed, with most big banks predicting a cut, traders in the fed funds market are now betting that rates will fall to nearly 1.5% by January. And the growing view that further rate cuts were likely sent stocks soaring on Aug. 6. "Weakness in the equity market has been significant, and the economic numbers have been poor," says Goldman senior economist Jan Hatzius. "The Fed has to respond." But does it? Greenspan dislikes being pushed into a move by Wall Street. And he's well aware that markets often overshoot on the downside. Indeed, some of the same firms now forecasting rate cuts were calling for higher rates last spring.

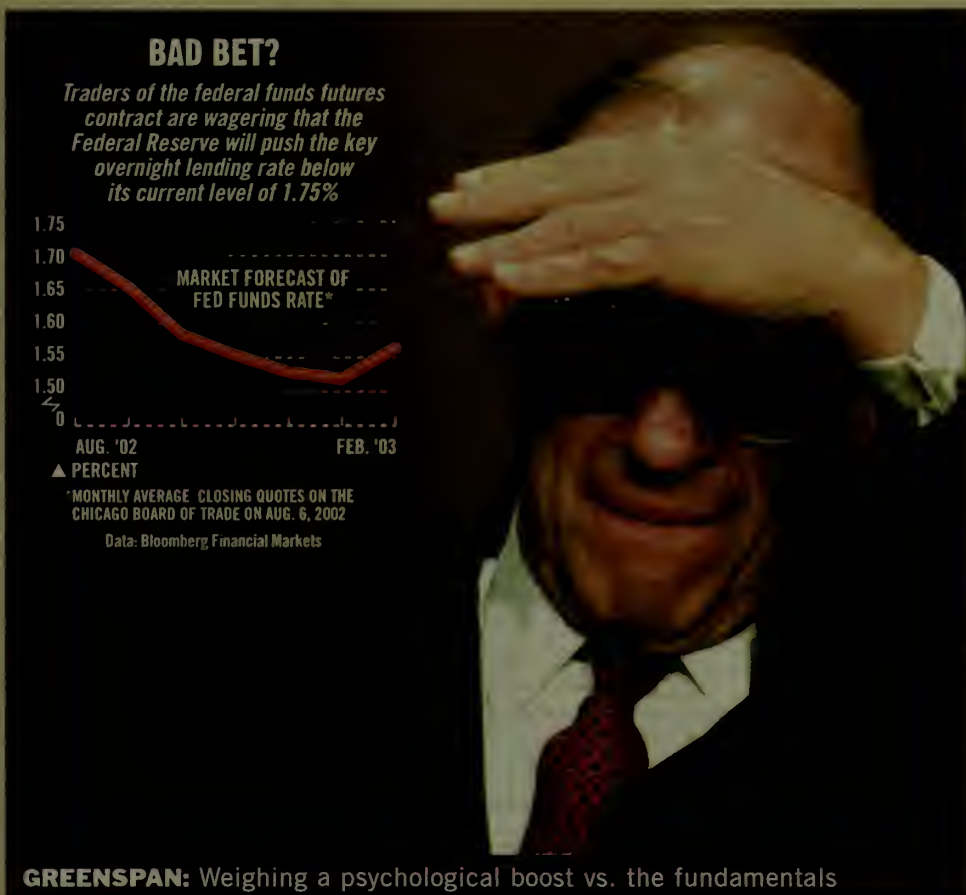
But fundamentally for Greenspan and his Fed colleagues, the problem is this: They're not sure today's bout of investor angst warrants an opening of the monetary spigots. While growth is likely to be slower than expected in the second half, Greenspan & Co. still doesn't expect a double dip. While a cut now might

it? Greenspan believes the nature of the 2001 slump dictates caution. While the economy contracted over three quarters starting in early '01, the recession was only glancing. That means the bounceback will be just as slight, without the surge that follows a deeper slump. Bottom line: a slow profits rebound and a poky recovery,

but a recovery nonetheless. To some Fed officials, that's not a scenario for more ease.

Then there's the issue of the Fed's depleted ammo. The central bank has cut rates 11 times and by 475 basis points since January, 2001. At this point, Greenspan must time additional cuts carefully. He must save them for when they're most needed rather than shooting bullets at phantoms.

None of this means that giddy optimism reigns at the



help psychologically, it may not be supported by the fundamentals—especially since housing and consumer spending are still holding up.

To the "cut now" crowd, the case for ease is compelling: Manufacturing's rebound has lost some of its zing. The service sector has been slow to perk up. A broad-based comeback in corporate profits looks elusive. And with no inflation on the horizon, the Fed appears to have the room it needs to trim rates.

"Greenspan always said the Fed doesn't respond to financial markets; it responds to economic events," says Steve Slifer, co-chief U.S. economist at Lehman Brothers. "Well, [the recent spate of bad economic data are] a real-live economic event."

So why not cut and be done with

Fed. The stock market bust wiped out an estimated \$6 trillion in equity since the market's peak in March, 2000. While a post-boom bloodletting is a precursor to a healthy rebound, officials admit the shock has reduced the economy's buffer zone and bears close watching.

Even if the Fed decides to follow the market's lead and signal at its Aug. 13 meeting a bias toward lowering rates later, Greenspan will still have to tread carefully. Thanks to Queen Elizabeth, he will soon be knighted. But with econo-jitters rising and the Fed looking a tad behind the curve to some, Sir Alan could soon be dodging lances from all sides.

Cohn covers economic policy from Washington.

GOVERNANCE

MAKING THEM GIVE BACK THE CASH

New laws aim to separate execs from allegedly ill-gotten gains

It was Scott D. Sullivan's \$15 million mansion—you know, the one with the six-car garage, 18-seat movie theater, and storage room just for fur coats—that got to Representative Richard H. Baker. When the Louisiana Republican read about the estate that WorldCom Inc.'s ousted CFO was building in Boca Raton, Fla., the outrage hit him: Why should anyone accused of bilking investors out of billions and bankrupting a company be allowed to slink off to a pleasure palace?

Sullivan is hardly getting off scot-free, of course. On Aug. 2, the Justice Dept. charged him with accounting fraud for allegedly boosting WorldCom's earnings by hiding nearly \$4 billion in expenses. Sullivan denies wrongdoing. But under current law, his personal holdings are

untouchable until Justice or the Securities & Exchange Commission wins a case against him. Until then, he is free to spend the \$45 million in bonuses and stock options he has received since 1999. The same goes for the lavishly compensated former execs of other companies under investigation, such as Enron, Adelphia Communications, and Global Crossing.

To stop CEOs from living the high life while the SEC and Justice probe their former companies, Baker plans to propose legislation in September that would allow the government to seize assets and place them in escrow until their owners' innocence or guilt is determined. If Sullivan is convicted, says Baker, his estate would be auctioned off, like a convicted drug dealer's, and the proceeds distributed to shareholders.

Sound far-fetched? Maybe. Freezing and seizing the assets of high-level execs won't be easy. True, the courts generally have upheld laws aimed at confiscating drug dealers' assets prior to a conviction, and extending those laws to include securities fraud would be fairly routine. But CEOs have numerous ways to protect assets from the feds, such

as walling them off in a child's limited liability company, offshore investment, or, for that matter, a house in states such as Florida. Baker's proposal, moreover, would have to overcome skeptics who worry that it's a troubling due-process and Constitutional issues.

Congress is expected to see a dozen new bills in September would change laws governing bankruptcies, pensions, and class action suits with an eye toward recovering the allegedly ill-gotten gains of corporate executives. Money could reach into the billions given the oversized options, bonuses, and golden parachutes granted in recent years. "There are enough zeros now that it's beginning to get interesting," says University of Texas law professor Henry T.C. Hu.

Until now, the government's strongest weapon has been an arcane tool called disgorgement. When the SEC wins a court order or settles a case against executives for securities law violations, it requires them to give back their compensation, including stock gains. Yet the SEC settled a securities fraud case against software company MicroStrategy Inc. in late 2000, for example, Michael J. Saylor and two other executives agreed to give up \$10 million in stock sales.

What's possible in theory often does not translate to reality, however. Since fiscal 2002, the SEC has won orders forcing execs to disgorge \$632 million, but has retrieved only \$73 million of that—just 12%. The main reason? Often there's little money to collect because it has been spent on legal fees or sequestered out of sight of SEC lawyers.

The government might be able to collect more cash in the near future. A little-noticed provision in the Sarbanes-Oxley Act, which went into effect in 2002, requires CEOs and CFOs of companies that restate their accounts because of "misconduct" to disgorge their bonuses and stock option gains—and the law does not require the agency to compel executives to the misdeeds.

One unintended consequence of the law, warns Del Mar (Calif.) lawyer Robert J. Mintz, is that it could encourage CEOs to move funds offshore to avoid a trace—just in case. "Every CEO in the country is going to take steps to protect his assets," says Mintz. So despite the best of intentions, Congressional attempts to reclaim allegedly tainted loot may not add up to much.

By Paula Dwyer, with Amy Borucki and Dan Carney, in Washington and Mike France in New York

CAN THEY TAKE IT WITH THEM?

What some execs pocketed in bonuses, stock sales, and company loans during the periods for which their businesses are now under investigation:

Kenneth Lay

ENRON

\$184 million

(1997-2001)

Scott Sullivan

WORLD COM

\$45 million

(1999-2002)

Dennis Kozlowski

TYCO INTERNATIONAL

\$332 million

(1999-2001)

Gary Winnick

GLOBAL CROSSING

\$123 million*

(2001)

Data: SEC, Thomson Financial

*Stock Sales Alone

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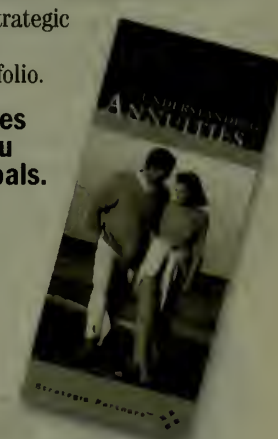
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CORPORATE REFORM

IF YOU DON'T OPEN YOUR BOOKS, WE'LL CANCEL YOUR POLICY

Insurers are demanding full disclosure from clients

Since the wave of scandals that have engulfed Corporate America began last fall, some of the most vociferous calls for reform have emanated from disgruntled shareholders, Congress, and the enforcement community. Now, a new player is stepping up—one that, while far quieter, could ultimately have a big hand in forcing companies to clean up their accounting and governance practices. The tough new enforcer? The insurance industry, where companies that write the policies covering corporate execs are threatening to cancel policies if executives don't open their books to scrutiny and prove that they are squeaky-clean.

Indeed, in recent months, top providers of so-called directors and officers (D&O) liability coverage—including American International Group (AIG), Chubb, and Lloyd's of London—have been demanding all that and more. That's hardly surprising. After all, these insurance companies are the ones left paying most of the damages when investors sue over financial restatements, bankruptcies, dubious accounting, or other practices.

Spurred by a rapid escalation of shareholder lawsuits—and the fear of more to come as senior officers at large U.S. companies are forced to swear to the accuracy of their financial statements—insurers are demanding a lot more corporate prudence. "They've definitely caught the attention of our clients," says Steve Anderson, a managing director at Marsh Inc., which arranges insurance for corporations.

Leading the charge is AIG—the U.S.'s

largest underwriter of D&O coverage. It's hiring more specialists in forensic accounting, demanding more financial data from clients, and grilling top executives on their track records and knowledge of the numbers. Others are doing similar due diligence and demanding top-notch management practices, accounting standards, and a strong board. The alternative: vastly higher premiums or no coverage at all. No wonder Ralph E. Jones III, president and CEO of Chubb Specialty Insurance, is finding that execs are "willing to give us a lot more information."

Not that they have much choice. Chris Warrior of Faraday Underwriting Ltd., a Lloyd's insurer, says his company is rejecting coverage for clients that have dubious revenue-recognition practices, poor internal controls, or other red flags. "We're very much turning away business," says Warrior.

Indeed, insurance companies claim that their corporate clients are tripping all over themselves to meet the new demands. Anxious CEOs are giving them unprecedented access in an effort to hold on to adequate, affordable coverage at a time of increased risk. Warrior says senior executives are actually asking what they can do to lower premiums. Some are even coughing up confidential outside audit reports. "We would ask for that a few years ago, but we wouldn't get it," says John Keogh, presi-

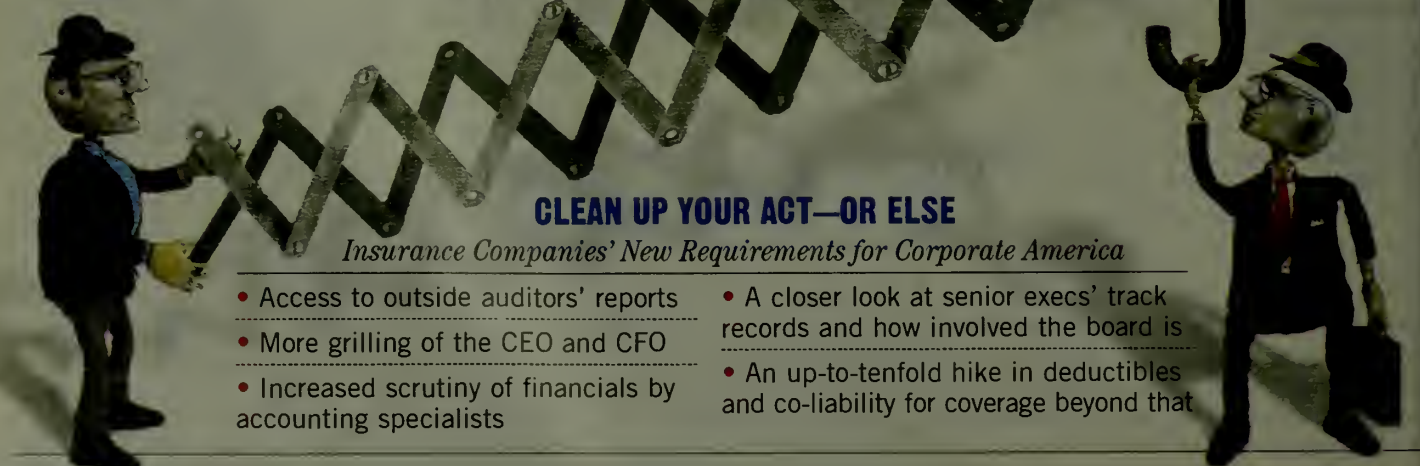
dent and chief operating officer at tional Union Fire Insurance Co. AIG arm that underwrites 22% of AIG's D&O policies.

Even so, D&O premiums have risen in recent months in tandem with increases in federal securities-fraud class actions and costlier settlements. Last year, corporations might have paid a few hundred thousand dollars a year to protect executives or directors from litigation. Today, the same coverage costs at least \$1 million. Moreover, AIG and its competitors are imposing multimillion-dollar deductibles and forcing companies to pay the cost of any claim beyond that.

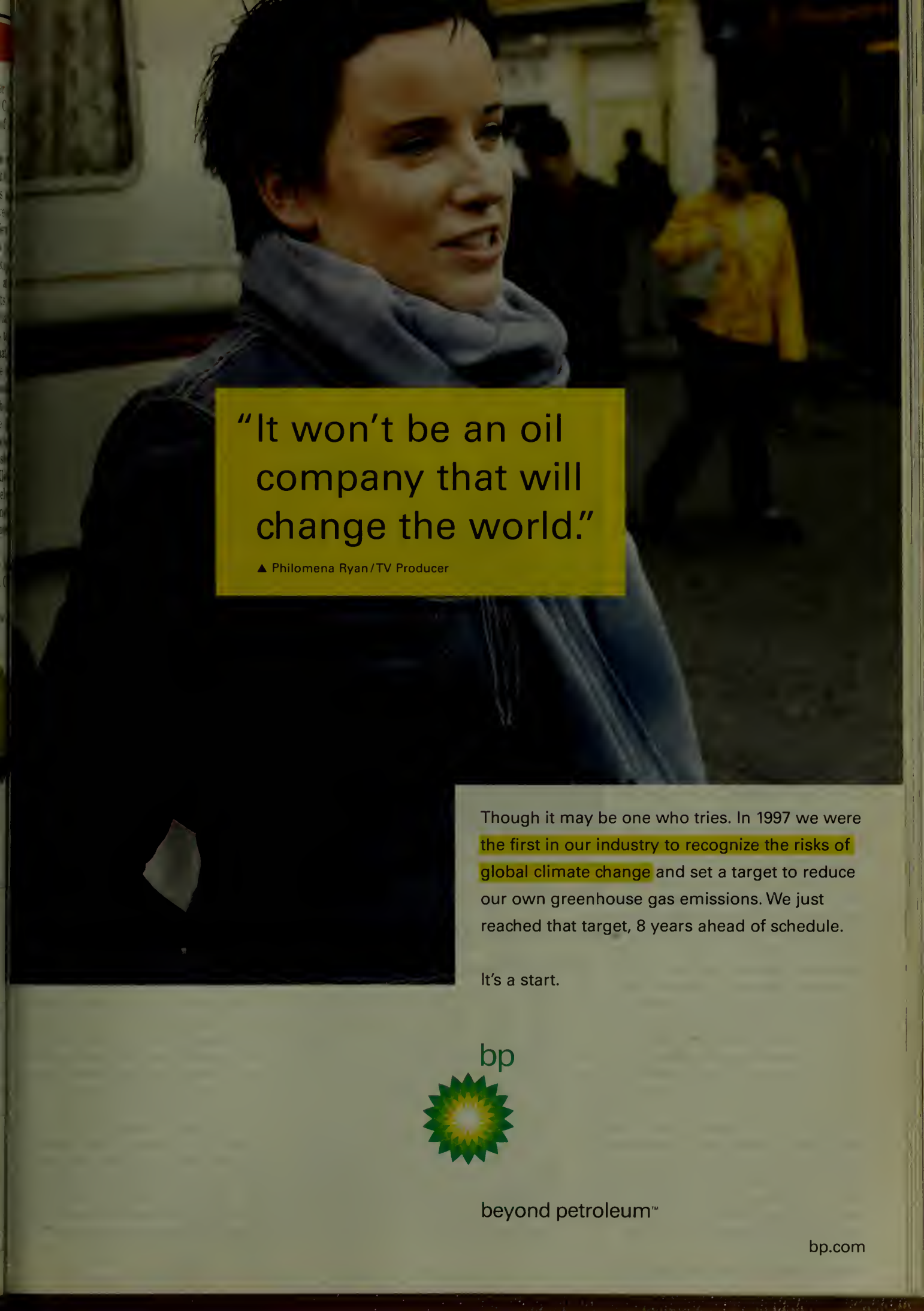
Despite the higher costs, the more assertive insurance industry should ultimately be a boon to shareholders. Companies can't afford to have inadequate coverage at a time when reeling directors and pleasing investors are tough enough. It's especially challenging for those in the technology or telecommunications sectors—not to mention companies that have already been in the headlines.

Clean books, real numbers, strong management, and strong boards. Call that an insurance policy.

By Diane Brady in New York



- CLEAN UP YOUR ACT—OR ELSE**
Insurance Companies' New Requirements for Corporate America
- Access to outside auditors' reports
 - More grilling of the CEO and CFO
 - Increased scrutiny of financials by accounting specialists
 - A closer look at senior execs' track records and how involved the board is
 - An up-to-tenfold hike in deductibles and co-liability for coverage beyond that



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▲ Philomena Ryan/TV Producer

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INSURANCE FRAUD

HEALTH-INSURANCE SCAMS THAT WILL MAKE YOU SICK

Unlicensed companies are conning hundreds of thousands—and the epidemic is growing

In June, 2000, Lisa and Dennis Huffstutler were thrilled with their new health insurer, Vanguard Asset Group. Its plan, sold via a trade organization Dennis belonged to, was cheaper than their expiring Blue Cross Blue Shield of Florida HMO policy—\$4,800 a year, vs. \$5,064. They could choose their doctors. And it covered existing conditions—a big plus since Lisa and their 4-year-old son have chronic medical problems.

A year later, their view changed drastically. Hospitals and doctors were dunning them for \$15,000 in unpaid claims. Contacting Vanguard—which has no connection to the mutual-fund family—did no good. “They would say things like, ‘The doctors used the wrong code’ or ‘The check is in the mail,’” recalls Lisa, who was pregnant again. She began to fear that her obstetrician would drop her.

Just before the baby was born, the West Palm Beach (Fla.) couple learned what was wrong. The Florida Insurance Dept. issued a cease-and-desist order on May 14, shutting down the Lake Success (N.Y.) company. The order alleged that Vanguard was an illegal, unlicensed operator run by Dwayne Samuels, who pled guilty in September, 2000, in U.S. district court in Brooklyn, N.Y., to health-care fraud in connection with the embezzlement of \$8 million from another insurer, Fidelity Group Inc. of Great Neck, N.Y. (The company has no tie to the Fidelity Investments fund family.) The U.S. Labor Dept. had obtained a court judgment in Feb., 2001, barring him for life from involvement with federally regulated health plans. Florida Insurance Dept. officials estimate that Van-



Labor Secretary Chao says the operators are “the most despicable people around”

THE HUFFSTUTLERS: \$20,000 IN THE HOLE

guard bilked at least 100 policyholders in the state out of more than \$500,000. The department has launched a full investigation and may seek criminal charges against Samuels, whom regulators say hasn’t responded to its order. Efforts to reach Samuels by phone and letter for comment were unsuccessful.

Luckily, Lisa’s doctors kept her on. She delivered a healthy girl on June 11. But, the family’s unpaid medical bills have ballooned to \$20,000. Lisa is uninsured. Dennis and the kids have only catastrophic coverage.

It’s boom time for medical insurance scams that collect premiums, pay for any, claims, then skip town. Vanguard is the sixth unlicensed insurer Florida has shut down in the past 18 months. Colorado has issued cease-and-desist orders against 43 in the last 15 months. Oklahoma has more than 60 investigations open. Texas, California, and Georgia all report big spikes in complaints of unpaid claims, most of them suspected cases of fraud. The U.S. Labor Dept. has civil and 14 criminal investigations as of June 30. “The [operators] are the most despicable people around,” says Labor Secretary Elaine L. Chao.

A *BusinessWeek* tally of state shows that three of the largest-employers Mutual LLC (no connection to the legitimate Employers Mutual Fidelity Co. of Des Moines), American Benefit Plans, and TRG Cos.—collected more than \$50 million in premiums from

65,000 people. None of the companies replied to requests for comment.

camouflage their scam, the eleon-like operators all use similar. With slick brochures, flyers, and media campaigns, they pitch their ces to real professional groups or membership in phony ones as a way t insurance. The names mimic those ell-known companies or organiza Vanguard Group—the mutual-fund any—says the bogus insurer agreed to stop using the Vanguard name last April after it filed suit.

Feeding the scams is a 25%-plus rise in premiums since 1998. Insurers are passing on the cost of restoring benefits slashed by managed care. That has become a big burden in a weak economy. Many businesses—which pay most insurance costs—have cut coverage or raised employee contributions. They now pay on average \$221 per month for individuals and \$588 for families, up from \$173 and \$463 in 1998, the Kaiser Family Foundation says. Scamsters particularly target freelancers—like Dennis Huffstutler, a wedding videographer—or small-business owners, who can't negotiate better rates with legitimate insurers.

Health-insurance fraud surges in recessions as people lose jobs and coverage. But today's scale is unprecedented. "It's much worse now than it was in the late 1980s. And it is going to go on for a number of years," says Mila Kofman, assistant research professor at Georgetown University's Institute for Health Care Research & Policy for a former Labor Dept. investigator.

crazy-quilt regulatory system is cover for scams. States regulate ers under the 1945 McCarron-Fer on Act. But the 1974 Employee Re- nent Income Security Act exempts us run by unions or single employers state regulation. Plans serving mul- employers—including those sold via e groups such as the 4,000-member dding & Event Videographers Asso- on International, which offered Huff- ler's Vanguard policy—need state li- es. But the overlapping jurisdictions ate confusion that unlicensed insur- exploit.

hockingly light penalties add to op- ors' sense of impunity. In many es, selling insurance without a license misdemeanor. Cease-and-desist or- s do little good in states like Florida re regulators lack police power to est suspects and seize assets. Alerted,

scamsters close up shop and move on. Poor coordination between state and federal officials hampers efforts to use antifraud laws. State regulators complain that federal investigations take years to complete.

The magnitude of health-insurance fraud has finally forced state and Labor Dept. officials to act. They formed a joint task force in spring, 2001, to share data and get the word out to small businesses. This year, the Florida legislature made

A GROWTH BUSINESS

*Three of the biggest
unlicensed health insurers
spread nationwide*

AMERICAN BENEFIT PLANS

Formed in 2000 by Robert David Neal, North Richland Hills (Tex.)-based ABP signed up 31,500 people in 48 states, Puerto Rico, and Mexico. It collected at least \$30.5 million in premiums.

When a Texas court's permanent injunction shut it down in May, 2002, it had some \$13 million in unpaid claims. It's now under a court-appointed receiver.

EMPLOYERS MUTUAL LLC

Incorporated in July, 2000, and run by James Graf, whom California regulators barred for life from the industry in 1998, the Carson City (Nev.) insurer signed up over 29,000 people in 37 states. A Labor Dept. permanent injunction shut it down in Feb., 2002. It collected \$15 million and left at least \$22 million in unpaid claims. (No tie to Employers Mutual Casualty Co. of Des Moines.)

TRG COS

Incorporated in Carson City in January, 2001, TRG had 12,288 customers in 44 states. Six have issued cease-and-desist orders. Indiana regulators say it collected \$17 million in premiums. The company says it paid a total of \$12 million in claims.

Data: Texas Insurance Dept.; U.S. District Court, Nevada; Indiana Insurance Dept.

the sale of fraudulent insurance a third-degree felony punishable by up to five years in jail. Texas and Georgia regulators now use their police powers more aggressively. President George W. Bush has endorsed a bill setting federal authority and solvency guidelines for multi-employer health plans, but broader health-care battles have bogged it down.

Employers Mutual is the biggest and most persistent health-insurance scam, regulators say. Incorporated in Carson City, Nev., two years ago, it was operated out of California by James L. Graf. The California Insurance Dept. permanently banned Graf from doing business in the state in 1998 after at least three HMOs and insurers he controlled went bankrupt. According to a February, 2002, Labor Dept. injunction ordering the company permanently shut down, Employers Mutual sold policies via 16 fictitious associations with such names as the Association of Barristers & Legal Aids and the Association of Cosmetologists. It also took in real groups such as the National Writers Union, which represents 7,000 freelance journalists.

Albert Piantadosi, the 56-year-old owner of a direct marketing company in Deerfield Beach, Fla., bought an Employers Mutual policy through the Communications Trade Workers Union, a name that resembles the Communications Workers of America, a prominent union. The Communications Trade Workers Union was an affiliate of Employers Mutual. At the time federal regulators shut it down, Piantadosi was awaiting a \$450,000 liver transplant. Miami's Jackson Memorial Hospital confirmed that it initially rejected him for the surgery after Employers Mutual went bust. Piantadosi's desperate wife, Joan, held a news conference to publicize his plight. The couple even sent a telegram to President Bush and Florida Governor Jeb Bush. The hospital later approved Piantadosi's operation and absorbed part of the cost. But he still owes \$250,000.

Unfortunately, even when the culprits are caught, victims seldom get any money back. Dwayne Samuels, who pled guilty to fraud in the Fidelity Group case, only agreed in Feb., 2001, to begin paying back the money to settle a suit the Labor Dept. filed against him in December, 1998.

With premiums rising and more people losing coverage, the pool of potential victims keeps growing. As countless Web listings and flyers extolling astoundingly cheap policies attest, scamsters think they're in a growth business. Alas, they're right.

By Brian Grow in Atlanta

EXECUTIVE SUITE

CAN MILLER PUT THE OOMPH BACK IN AOL?

The new CEO has to find ways to build customer loyalty

When Jonathan F. Miller reported for work on Aug. 6 at America Online Inc., few employees of the stumbling Internet giant realized their unassuming new CEO walks softly but carries a big stick—literally. An accomplished practitioner of the martial art of kung fu, Miller's forte includes traditional Chinese swordsmanship. And yes, Grasshopper, the student is devoted. Miller periodically flies to London to work with his kung fu master. "It might come in handy" in his new job, he deadpans.

No kidding. A former top exec at USA Interactive Inc., Miller, 45, needs all the weapons he can muster to keep from becoming another casualty of AOL's ongoing financial woes. Slower advertising and subscriber growth and federal investigations of accounting at the online unit have helped send parent AOL Time Warner Inc.'s stock down roughly 75% in a year, a swoon that cost ex-AOL CEO Barry M. Schuler and Robert W. Pittman, AOL Time Warner's former COO, their jobs.

So can Miller pull AOL out of its slump? To do that, the Net-savvy exec will have to boost ad revenues and bring in subscribers even as he devises a better plan to persuade AOL users to switch from dial-up services to broadband. He has one edge already: a track record of figuring out how to profitably leverage the combined strength of USA Interactive's Internet, broadcast, and cable units. He negotiated a complex deal, for example, to broadcast games and sell sports collectibles on the Home Shopping Network while hawking tickets online via Ticketmaster. Miller also has the backing of the new chairman of AOL



MILLER: One task will be getting users into broad-

interests. site will... bers to inter... chats with the... vorite celebrit... enable fans of... lar TV shows to

The scheme from a sure-fire... however. Many... companies have... tempted such p... alization before... out success. "Th... is littered with... panies that th... they'd go to o... one marketing... David Card, a s... analyst at Ju... Research. One... hurdle: For the

Time Warner's Media & Communications Group, Don Logan. "Don and I will be in lockstep developing an overall business model," Miller pledges.

Miller and Logan will likely take until late fall to hammer out a comeback plan for AOL, but a blueprint is already taking shape under existing top AOL managers. A page from Logan's own success as former CEO of Time Inc. and, indeed, from Old Media could be key. Like Time, AOL wants to lure more subscribers by tailoring content to individual tastes—and then charging advertisers more for reaching a narrowly target-

ed audience. "It's the classic strategy for every consumer product that has reached a stage of maturity," says AOL Time Warner adviser Peter A. Kreisky of Kreisky Media Consultancy.

With AOL 8.0, the new version due out in October, the company will begin experimenting with the concept. Subscribers will be able to choose one of six user profiles—such as newshound or entertainment junkie. They will then get a customized welcome screen highlighting content and services keyed to their

ice to work, AOL will likely need personal information that users may be reluctant to provide for fear of intrusive more pop-up ads.

But audience segmentation clearly fits with Miller's aim of attracting and keeping subscribers by offering more for AOL's \$23.90 monthly rate. To end, he's looking at jazzing up programming to make AOL a "must" ISP. He also wants to offer AOL's active members benefits ranging from exclusive music downloads to discounts on merchandise and services. "Membership should have its privileges," he says.

Will it be enough to jump-start the troubled online giant? While such a move could help burnish AOL's dial-up image, it's far from clear that they draw enough new or higher-paying advertisers to make a big difference. It also does little to resolve the far larger problem looming on the horizon: AOL must create unique content that can persuade users to jump to broadband. And with shareholder grumbling growing louder, he has to move fast. It's up to Miller to prove he's a kung fu master and not just fodder for swift swordplay by angry investors.

By Catherine Yang in Washington

AOL'S REHAB PROJECT

CREATE A MUST-SEE ISP

To wow users, AOL aims to create hot content such as celebrity chats or exclusive previews of new cars

BUILD BONDS WITH USERS

The goal is to bolster AOL's strength as a home for Web communities by making it easy to find relevant chat rooms or share such things as lists of favorite movies or recipes

CUSTOMIZE CONTENT

The upcoming AOL 8.0 will let programmers deliver content and services better tailored to individual tastes—which will eventually let advertisers pitch to more targeted audiences

ENHANCE BENEFITS

AOL will offer its most active users perks such as exclusive music downloads and special discounts for merchandise and services



AT&T Wireless



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AUTO MAKERS

FOR GM, SWEET DEALS ARE SMARTER THAN THEY LOOK

They're winning market share—and not hurting profits much

When General Motors Corp. revived 0% financing in early July, Wall Street hissed. Investors dumped the stock, worried that the auto maker was putting market share before profits. Others felt the incentives would hurt the rest of the industry, hooking buyers on fire sales. Goldman, Sachs & Co. senior analyst Gary Lapidus went so far as to call the ongoing incentive strategy "destructive."

Maybe, but there is more to this than meets the eye. GM execs acknowledge that the incentives could hurt margins in the short term. But they aim to capture new customers now in the hopes of creating a cadre of loyal GM buyers that will still be around when a raft of promising new models starts hitting showrooms in 2004. "If you have a vehicle people really want," says William J. Lovejoy, GM's group vice-president for sales and marketing, "you don't [need] incentives."

For now, the cheap financing is mostly helping the auto giant win a price war that its weakened rivals can ill afford. After the No. 1 auto maker beat Ford Motor Co. and DaimlerChrysler to market with 0% financing in July, GM's monthly sales soared 24% over the previous year. By contrast, Ford's July sales inched up 1%, and Daimler sales fell 4%. Both Ford and Chrysler responded by offering 0% financing as well; Chrysler has even extended warranties to seven years and 70,000 miles on all cars.

The matching deals haven't stopped either from losing ground to GM, how-

ever, since its lineup features newer models. Indeed, Ford's market share has sunk two points, to 20%, this year, and Chrysler's is down marginally to 13.5%. Meanwhile, GM has jumped from 27.7% to 28.5%. Says Michael E. Marroone, president and chief operating officer of AutoNation Inc., the nation's largest dealer chain: "GM is getting its



GM: Trying to build a loyal customer base

share gains from Ford and Chrysler."

The battle has been toughest on Ford, which is still struggling to recover from last year's meltdown. After reporting slim profits in the second quarter, the company expects third-quarter losses and only a slight gain for the whole year. "The incentive war has been costly," says Ford Chairman and CEO William C. Ford Jr. "It's up to us to get our business in order so that we can be profitable no matter what's going on in the marketplace."

For its part, Chrysler is hoping to sidestep the incentives war—thus far unsuccessfully—with an emphasis on quality. The company has invested billions to improve its engines and transmissions. Says James C. Schroer, Daimler's executive vice-president for global sales and marketing: "We want to put

the product first and the deal second."

That won't be easy. GM has the financial muscle to keep the incentives going. After a decade of belt-tightening, variable costs are now in line with Japanese, at about 62% of revenue versus 70% for Ford and Daimler, says UBS analyst Saul Rubin. So GM can use its cost advantage to boost incentives.

The cheap financing has hit GM's bottom line—but not as much as investors feared. Analysts estimate that 0% financing costs \$3,100 a vehicle, \$500 more than GM was spending on sweet leasing deals in June. But the jump in sales means GM can run its assembly lines faster. That translates to higher productivity, which helps defray the cost of 0% financing. By one

Incentive Wars

GM

Cash rebates of \$2,500 to \$4,000 for most cars, and 0% to 2.9% for five years on most trucks and SUVs

COST PER VEHICLE \$3,109

CHRYSLER

Cash rebates up to \$3,000 or 0% loan for five years on most minivans and SUVs, plus seven-year, 70,000-mile warranty on engines and transmissions

COST PER VEHICLE \$2,752

FORD

Cash rebates of \$1,500 to \$3,000, or loans at 0% for three years, or 1.9%, 2.9%, or 3.9% for select vehicles and loan terms

COST PER VEHICLE \$2,619

Data: Automotive News, Autodata

mate, GM would need to grab at least a point of market share for 0% to break even on the bottom line. Since July, GM gained just 1 point in July, the schedule hurt profits. Still, Burnham Securities Inc. analyst David Healy says GM should hit its third-quarter earnings target of \$500 million.

Will today's discounts build the customer loyalty that GM needs tomorrow? The company is counting on its next generation of cars and trucks, designed under car guru Robert A. Lutz, hired last year to add luster to GM's lineup. Coming soon is a Cadillac SUV, a retro-styled Chevrolet compact wagon, and the Pontiac sports car. Lutz had better get it right. Otherwise, GM may lose the market share it bought these past 12 months.

By David Welch, with Kathleen Kerwin, in Detroit

A PERSPECTIVE ON VALUE INVESTING

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the Mutual Discovery Fund has been negative, it has generally performed well over the long term. For example, the fund received a 5-Star Overall Morningstar Rating™ by Morningstar, Inc., against a category of 241 and 164 world stock funds for the 3- and 5-year periods respectively, ended 6/30/02.* Of course, past

Mutual Discovery Fund | Morningstar Ratings™ 6/30/02†

OVERALL
★★★★★

THREE YEAR
★★★★★

FIVE YEAR
★★★★★

TEN YEAR
N/A

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†Source: MORNINGSTAR® 6/30/02. Past performance does not guarantee future results. For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating™ based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.) The Overall Morningstar Rating for a fund is derived from a weighted-average of the performance figures associated with its three-, five- and ten-year (if applicable) Morningstar Rating metrics. Morningstar Rating is for Class A shares only; other classes may have different performance characteristics. For more current performance information, please call Franklin Templeton Investments at 1-800-342-5236.

BWK9/02

In Business This Week

EDITED BY MONICA ROMAN

VCs TO INVESTORS: THANKS ANYWAY

VENTURE CAPITALISTS HAVE set a dubious record. For the first time, VCs sent back more money in a single quarter to their investors than they raised from them. According to researcher Venture Economics, seven firms cut the size of their funds by a total of \$2.7 billion in the second quarter of 2002, while 30 firms collectively raised \$1.8 billion. The \$2.7 billion can't really be considered a refund, since venture capitalists only collect money when they need it. Rather, VCs are releasing their investors from \$2.7 billion in commitments. The trend is more evidence of how overheated—and overfunded—the venture-capital industry became during the heady '90s. And it also demonstrates how even top-tier venture-capital firms are struggling in today's tough business environment. The \$2.7 billion was returned by such veteran VCs as Accel

Partners and Charles River Ventures.

BUSINESS FLIERS REJOICE—PRICE WAR!

IN THE FACE OF WEAK DEMAND, American Airlines quietly tried to cut business fares by 10% by offering discounts through certain travel agencies. But the move prompted an aggressive response by Northwest, which fired back with published business-fare cuts on Aug. 2. Since then, the cuts have escalated to 40% off the highest unrestricted fares in some markets. Other airlines have joined the fray on certain routes for travel ending next June. Even before the price war, airlines were expected to lose \$5.4 billion this year.

CISCO CAN'T SAVE TECH

WHAT'S GOOD FOR CISCO Systems isn't necessarily good for industry prospects. Shares of the networking giant inched up 8%, to \$12.99, on Aug. 7, one day after it reported better-than-expected fourth-quarter profits of \$772 million on a 12% sales gain, to \$4.8 billion. But Cisco's ability to wring out profits doesn't signal a thawing in the tech industry. Cisco beat estimates with help from increased efficiencies, a slightly reduced workforce, and cheaper component costs. While CEO John Chambers predicts flat or slight seasonal growth in the upcoming fiscal first quarter, "we're a little bit more cautious" than in the last quarter about market conditions.

NESTLE EXPANDS ITS FROZEN ZONE

LESS THAN TWO MONTHS after announcing a \$2.6 billion merger with Dreyer's

HEADLINER: PATRICK RYAN

HITTING A ROUGH PATCH

AON CEO PATRICK RYAN HAS transformed the little-known Chicago company into the world's second-largest insurance broker. But Ryan's legacy may be in danger. On Aug. 7, Aon said it only broke even in the second quarter because of charges, lower margins, and reduced investment income. "It was an absolutely abominable quarter," Ryan admitted in a conference call.

Worse, Aon said it may have to restate four years of financial reporting after being questioned by the Securities & Exchange Commission. Wall Street

punished the stock, sending it down 30%, to \$14.77. Aon looks weak vs. its archrival, Marsh & McLennan, which flush because of soaring insurance premiums posted September 11. Aon has also lost staff to competitors and has had trouble integrating acquisitions. "Patrick kind of reminds you the slugger who stayed two years too long, wrecking a great career," says Bear Stearns analyst Michael A. Smith. Indeed, the bad news is putting pressure on the 65-year-old Ryan to consider an exit before things get worse. *Pallavi G.*



CLOSING BELL

AD GAMES?

Interpublic Group shares fell 32%, to \$13.40, in the two trading days ended Aug. 6, after the advertising and marketing holding company said it would postpone its second-quarter earnings release by a week, to Aug. 13. Questions are being raised about the accounting of client billings.



Grand Ice Cream, Nestlé is expanding its freezer section again. On Aug. 6, the Swiss food giant said that it will acquire frozen-food maker Chef America for \$2.6 billion in cash. The deal will add the Hot Pockets, Lean Pockets, and Croissant Pockets brands to Nestlé's frozen-meal lineup, which includes Stouffer's and Lean Cuisine. Privately held Chef America, based in Denver, is expected to generate sales of \$720 million this year. Although some analysts saw the deal as pricey, Nestlé CEO Peter Brabeck-Letmathe defended it as key to raising the company's share of the U.S. frozen-food market.

IRESSA GETS A STEP CLOSER TO MARKET

ASTRAZENECA PHARMACEUTICALS' cancer drug, Iressa, cleared an important hurdle on Aug. 7 when the Food & Drug Administration sched-

uled it for assessment on a panel of experts on Sept. 10. If the panel recommends Iressa, one of the first in a new wave of targeted cancer therapies, it is possible the drug will be approved for marketing by yearend. Some have speculated that the FDA may delay the drug, a potential blockbuster, until it reviews results from late-stage clinical trials to be released in December. But analyst Catherine Arnold of San Francisco's Bernstein says the interim data are strong enough to support Iressa's approval.

ET CETERA...

- Ex-ImClone Systems' Samuel Waksal was indicted on federal insider trading charges.
- The Milton Hershey School asked Pennsylvania legislators to stop Hershey Foods' sale.
- Penn National Gaming agreed to buy Hollywood Casino for about \$780 million.



ENERGY 2002

Meeting global energy needs — responsibly

Energy companies are in a “back-to-basics” mode, and they are looking at infrastructure security as a huge new element of responsibility for their industry.

No question, Homeland Security promises to deeply impact the energy sector. Nuclear power stations, major natural gas pipelines, petroleum and finished product tank farms, refineries, and other facilities need “hardening,” along with the communications systems that support them. This promises to be a fertile area for innovation in the years ahead.

Fortunately, much of the work done as part of Y2K programs can be rolled over to Homeland Security. Security objectives are sure to require a larger role for government, even as deregulation seeks to limit the state and federal roles and allow efficient energy markets to take over.

While the administration and Congress seek to re-align federal agencies for Homeland Security, one thing appears certain: National security

State and federal governments and regulators need to create a more certain investment climate

will become an important "optimizing" element in the selection, design, and operation of energy facilities. Tradeoffs will have to be balanced among security, environmental impact,

capital investment, operating costs and siting.

What might this mean for different sectors? The United States Energy Association (USEA), Washington DC, advocates the following, several elements of which have particular import to petroleum companies:

- One government agency tasked with the oversight and coordination for all energy infrastructure systems
- Filling of the strategic petroleum reserve
- Enhancing international cooperation in preparing for oil supply disruptions

Shifting global politics

Perhaps it's a little early to draw the correlation, but if America's role in the Middle East continues to deteriorate and our relationship with Russia continues to improve, then supply lines through Europe and to the U.S. could change. Take a look at petroleum and natural gas supply reserves in Europe, and you'll see that Russia possesses the lion's share. Long-term, oil companies are preparing for such outcomes.

The decade-long march of US energy companies to develop projects in far-flung parts of the globe under newly minted privatization programs appears to have slowed. Many companies have backed away from Asian and Latin American projects; more recently, many unregulated subsidiaries of US electric utilities have sold most of the distribution and generation assets they bought in the UK. Europe is mixed, with some US firms getting out, but some staying in. Most observers, however, seem to think German and other European energy firms will be shopping for US assets.

Transmission

Almost completely left out of electricity deregulation and competition programs in the U.S. was transmission. Two reasons are: (1) transmission lines are interconnected and power flows

through paths of least resistance, so interstate commerce is involved and (2) transmission was considered a "natural monopoly." Now the Federal Energy Regulatory Commission (FERC) has stepped into the breach and seeks to create several "super" regional transmission organizations (RTOs) responsible for electricity markets.

FERC is moving in the right direction as the nation's transmission infrastructure could use updating. New power projects have trouble connecting to the high-voltage lines or getting transmission access contracts to move their power. Pioneering firms are willing to acquire or build transmission assets and they appear able to obtain financing and investment. Regulated utilities are also beginning to shake some money loose for this purpose.

State and federal governments and regulators need to create a more certain investment climate, achieve the RTO objectives with suitable corporate governance, and then move aside into an oversight role so the private sector can function. Opposition to new transmission lines could put the entire nation's electricity system, not just "markets," in jeopardy.

the federal nuclear fuel waste repository in Nevada, industry confidence grows in nuclear's long-term viability.

Energy, autos, and fuel cells

An interesting dynamic was revealed at the G-8 Energy Ministers meeting, sponsored by the United States Energy Association (USEA) and held in Detroit, MI, in May: Fuel cell technology could become a convergence point for the energy and the automotive industries.

Here's why: Fuel cells, powered by hydrogen, are a long-term solution to Detroit's need for cleaner, more efficient automobile "engines." When hydrogen is the fuel, the only significant emission is water vapor, at least from the fuel cell. The technology, similar to batteries, involves the chemical conversion of the fuel's energy into electricity. Traditional power systems are based on a mechanical conversion process, usually combined with combustion.

At the same time, many in the energy business, including fuel suppliers, utilities, and energy companies, see fuel cells anchoring a new electricity production and delivery concept called



Energy companies need to focus on their existing assets now that it's more difficult to raise money in the capital markets for new projects. One example of this is the nuclear industry. As the nation's nuclear power station assets get concentrated in fewer and fewer hands, these firms are investing to expand output and productivity. And why not? The incremental kilowatts are a fraction of the investment of new power plants, regardless of the fuel or energy source. There's even a renewed appetite for building new nuclear units, with the first ones possibly sited at existing facilities. As long as progress continues on Yucca Mountain, site of

micro- and mini-grids. These grids include small "distributed" power assets very near or at load centers that are automatically operated interactively to supply customer load or the grid, depending on load demand, electricity prices, etc. Fuel cells, at least some designs, are unique because they can produce electricity from a fuel—the cleanest is hydrogen but natural gas, methanol, and even coal-derived fuel gas work too—and can operate in reverse. That is, they can consume electricity and produce fuel.

POWER POSITION

[ANOTHER REASON PSEG HAS WALL STREET'S ATTENTION]

In the energy business, one key to being a successful player is strategic positioning in a stable, profitable marketplace. As a market leader, PSEG has helped make PJM (the Pennsylvania, New Jersey, Maryland network) one of the most highly regarded power pools in the U.S. It's a location which provides a sound trading environment, supportive regulations and extensive transmission access. But this doesn't mean the company is resting on its accomplishments either—PSEG continues to expand its generating capacity here to meet the burgeoning energy requirements of the region. Talk about being positioned for success.



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Stephen L. Baum Chairman, President and CEO

Sempra Energy Generates Impressive Results

During a time of high volatility and crisis in the energy industry, Sempra Energy has demonstrated that the source of *real* power is straightforward accomplishment. From meeting or exceeding its financial goals, to outperforming the major financial and peer company indices, Sempra Energy generates impressive results.

In 2001, Sempra Energy's return to shareholders was 9.9 percent, outperforming the Dow Jones Industrial Average, the Standard & Poor's 500 Index and the Standard & Poor's Utilities Index.

Based in San Diego, Sempra Energy is a Fortune 500 energy services corporation whose companies serve the largest customer base of any utility company in the United States. The Sempra Energy family of companies and its more than 11,000 employees provide an integrated package of energy-related products and services. Sempra Energy common shares trade on the New York Stock Exchange under the symbol "SRE." The company's Web site address is www.sempra.com.



New sources and technologies

With this year's extension of the production tax credits, the wind energy industry has been given a new lease. Projects that had been held up because of the delay in this legislation are now moving forward. The purchase by General Electric Co. of Enron Wind has also stirred some excitement for proponents of this key renewable energy source.

PSE&G has high expectations for microsensor technology (Public Service Electric and Gas is a subsidiary of PSEG, a Newark N.J.-based diversified energy company) — "smart sensors." This technology has the potential to transform the electric and gas utilities of today into "smart utilities" that can anticipate problems and act to head off equipment failures or power outages before they happen.

Microsensors involve the super tiny world of microelectromechanical (MEMS) systems and nanotechnology. In the not-too-distant future, these sensors — smaller than human hairs — with "brains on-board," promise to give PSE&G unprecedented monitoring and diagnostics capabilities for its infrastructure, along with distributed data processing and analysis. These microsensors are already used in a broad range of applications in the medical, automotive, safety, defense, and security industries.

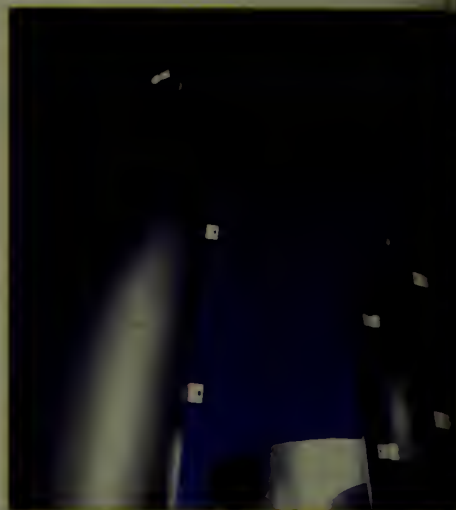
According to Al Keoppe, President and COO of PSE&G, the company is working to develop advanced transformer microsensors capable of detecting or predicting problems either with its equipment or its security. These sensors would be installed as part of local utility distribution infrastructure.

Keoppe notes that "microsensors designed with on-site intelligence, coupled with knowledge-based programming techniques like expert systems and neural networks, will help us in two ways. At a time when the security of our infrastructure has assumed increased priority, smart sensors will give our security people regular updates about what's happening in our infrastructure as well as what *might* happen." Smart sensors will also improve overall system security and reliability by continuously monitoring information and distributing intelligence. This will enable PSE&G electric system operators to diagnose and predict future operating states of its delivery system. In other words, they'll be able to tell what's going to happen in the system before it happens.

The last mile gets shorter

With its unique Fiber-in-Gassm technology Sempra Energy safely routes fiber cable through existing, live gas pipelines. Customers can get the

high-speed connections they need and telecoms can connect the last mile quicker, at a lower cost and with less time digging up streets and disrupting people's lives. And gas utilities have the opportunity to lease their pipeline space to the telecoms for new sources of revenue.



The 'fossil' backbone

Long-term options aside, the backbone of the nation's energy infrastructure is still fossil fuels and will be for decades to come. Many new coal-fired power plants are on the drawing boards, but natural gas is still the fuel that most stakeholders—environmentalists, utilities, politicians, community leaders — can agree on.

Companies like BP, while assuring the world of a plentiful supply of attractively priced natural gas, see a rising need for a robust liquefied natural gas (LNG) market in North America. But while most companies focus on the use of gas in transportation and electric power markets, BP adds the production of "syncrude" as an intermediate for cleaner diesel fuel, lubricating oils, and jet fuels.

As the world's insatiable need for energy rises daily so does need for innovative thinking, smart and responsible practices — a need that's being met in the laboratories and plants of power companies around the country.

Jason Makansi is president of Pearl Street, Inc. (www.pearlstreetinc.com) a business and technology deployment consulting practice based in St. Louis, MO. Makansi was previously editor in chief of *Power* magazine and director/power industry for *Myplant.com*, an information and engineering services portal for vertical industries.

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ED BY RICHARD S. DUNHAM

POWELL OF THE FCC: PRODDING WHILE TELECOM MELTS?

industry has been more battered by financial woes and corporate scandal than telecom. Companies like WorldCom and Global Crossing have come to symbolize tech high jinks and accounting gimmicks. But while actors such as Securities & Exchange Commission Chairman Harvey L. Pitt and Federal Energy Regulatory Commission boss Patrick H. Wood III morph from corporate spies to aggressive watchdogs, Federal Communications Commission Chairman Michael K. Powell seems to be sticking to the kinder, gentler approach.

In the midst of a \$2 trillion meltdown in telecommunications, Powell has not deviated from the off-course he charted at the beginning of his tenure two years ago. Arguing that telecom's woes are caused by market forces outside the FCC's control, he still pursues his original agenda: speeding broadband by deregulating the Bells and relaxing rules limiting concentration of media ownership.

Now, Powell's single-mindedness has begun to attract critics. Democrats such as Senators Ron Wyden (D-Ore.) and Frank Lautenberg (D-N.J.) accuse him of doing little to protect consumers and

refusing to develop a plan to revive the battered industry. "The problems...are more profound than soothing words one leader can solve," says Powell. "I'm not going to solve a \$34 billion debt problem of a major carrier just because I express optimism in its future." Still, a growing number of business reps say he hasn't been vocal enough in calming panicked investors. "This was the largest growth period of our economy," says one. "He should use his political capital to restore confidence."

Local phone companies such as Verizon Communications and BC Communications claim Powell hasn't addressed the possible domino effect on the industry if WorldCom can't make connections to local networks. "The chairman needs to move from proposing to disposing," says Walter B. Mc-

Cormick Jr., president and CEO of the U.S. Telecom Assn., which represents local phone carriers. "Nothing can be fixed by having the FCC sit on its hands." Another lobbyist calls Powell "the Herbert Hoover of telecom."

The FCC boss got a taste of the changed mood at a July 30 Senate Commerce Committee hearing. "The current climate requires a very different regulatory approach," lectured Wyden. One request from Dems: The FCC should step up oversight by expanding industry audits. Powell says he's considering that, but audits to assess phone company costs and help set rates may not root out financial fraud. Separately,

he issued public assurances to WorldCom customers that their service would not be shut off without notice only after prodding by Representative Edward J. Markey (D-Mass.). The FCC says it already had been working privately with WorldCom to protect anxious consumers.

Indeed, Powell says the FCC is doing "virtually everything in our authority that we can do." After WorldCom disclosed its \$3.8 billion accounting error on June 26, he made a quick trip to Wall Street to meet with investors and lenders such as Bank of America. And

as a member of the President's Corporate Fraud Task Force, he's providing expertise to Justice Dept. and SEC investigators building cases against alleged wrongdoers.

Up until now, Powell—son of Secretary of State Colin Powell—could count on friends in high places to shield him. Unlike Pitt, he has developed a network of supporters, including Senate Commerce Committee ranking member John McCain (R-Ariz.) and House Commerce Committee leaders W.J. "Billy" Tauzin (R-La.) and John D. Dingell (D-Mich.). "He has more political capital on the Hill than any Bush appointee," says Precursor Group telecom analyst Scott C. Cleland. But if the telecom blowups continue, Powell may find that his powerful backers can't keep deflecting the heat.

By Catherine Yang



ON THE HILL: Urged to get engaged

CAPITAL WRAPUP

EMILY IS LISTING

Will women be big losers in the term elections? EMILY's List, a political-action committee that backs pro-choice, women Dems, has a losing record so far this cycle. The most notable defeat came on Aug. 6 in Michigan when Representative John D. Dingell trounced fellow Dem Representative Lynn N. Rivers.

When redistricting threw both into the same district, Rivers mounted a happy campaign with the help of lib-

eral groups. EMILY's List gave her \$350,000. With Rivers' defeat, EMILY's has lost five out of nine, including bids in Illinois, West Virginia, and Tennessee. Certainly, the PAC can expect to lose a few, since it often backs women candidates despite long odds. And it wasn't all bad news in Michigan: Attorney General Jennifer Granholm overpowered two other Democratic candidates for governor, thanks in part to \$450,000 from EMILY's List. But it's not shaping up as a banner year.

WELLSTONE'S BRAINSTORM

► Paul D. Wellstone (D-Minn.), the Senate's reigning liberal, has not only out-raised Republican opponent Norm Coleman but added a populist twist to traditional dialing-for-cash: He's holding "time-raisers." Instead of money, Wellstone asks donors for two hours of time each week until the election. Coleman, meanwhile, has been getting help from the Commander-in-Chief himself; one fund-raiser with President Bush netted Coleman \$2 million.

TAIWAN

TAIWAN'S ANGRY MAN

Will Chen's independence rhetoric provoke Beijing?

It's just what this fragile world doesn't need: another full-blown Taiwan-China crisis. One that hammers investor confidence in the Pacific, undoes months of fence-mending between Washington and Beijing, and pushes Beijing into truculent actions it doesn't want to take.

The odds of such a crisis increased dramatically on Aug. 3. Taiwan President Chen Shui-bian declared in a speech that China and Taiwan are separate countries and called for legislators to consider authorizing a referendum on independence. Beijing has long threatened to invade should Taiwan officially break from the mainland. On Aug. 6, Chen stepped back a bit, saying that China and Taiwan enjoy "equal sovereignty." And Taiwan's military canceled exercises planned for Aug. 15. Even so, the Communist Party's mouthpiece, *People's Dai-*

ly, warned on Aug. 7 that "the chances of Beijing using military force to settle the Taiwan question may be heightened" if Chen pushes for a referendum.

Why would Chen risk ending the recent dance of détente between Taipei and Beijing—a dance he has helped choreograph? Political analysts say Chen is willing to gamble that he can score points politically at home without provoking China to launch any truly dangerous military action. His ruling Democratic Progressive Party, of which he recently became chairman, is facing an uphill battle in key mayoral elections in Taiwan's two largest cities in December. Another worry: Former President Lee Teng-hui's new pro-independence party, the Taiwan Solidarity Union, appeals increasingly to hardcore Beijing-haters in the DPP. And the po-



litically weak Chen may simply wanted Beijing to take him seriously. That's probably why Chen chose to make his comments to a pro-independence group. If China responds with heavy-handed rhetoric or military exercises in the Taiwan Strait, that could inspire voters to rally around the DPP in the local elections, which will set the stage for the next presidential vote in 2004. "It relates very much to domestic Taiwan issues," says a Western diplomat.

CHINA-BASHERS ARE BACK ON THE JOB IN THE U.S.

Taiwan and China aren't the only ones on a possible collision course these days. So, too, may be the U.S. and China. The Bush Administration had eased tense relations with Beijing after a crisis over the collision between a U.S. spy plane and a Chinese fighter jet was resolved in April, 2001. China's entry into the World Trade Organization last year ended acrimonious annual fights over normal trade relations with Beijing. The Bush team also halted another irritant, the yearly decision on arms sales to Taiwan. September 11 cemented the détente, as Beijing offered to aid the war on terrorism.

Now, though, the roller-coaster

Washington-Beijing relationship seems headed for another dip. The anti-China coalition in Congress that long fought the establishment of normal trade relations with Beijing has regrouped and is threatening new legislative actions this fall. Tensions over Taiwan may provide more ammunition for China-bashers. With China skeptics again speaking out, "China's top leaders understand that the relationship between the U.S. and China will surely go downhill in the next few years," says Yan Xuetong, director of Qinghua University's Institute of International Studies.

The resurgence of anti-China sentiment puts President Bush in a bind.

The Administration already includes hard-liners who worry that China could become a U.S. adversary. In late July, the Pentagon published a report on China's defense budget to be no more than the \$20 billion Beijing reports. But Bush can't play hard because he needs Beijing in the terrorism fight. The White House also needs Chinese acquiescence at the Security Council if the U.S. tries to oust Iraq's Saddam Hussein.

The President's current stance is likely to deter the rejuvenated China coalition, however. The loose-knit group unites Republican

SABER-RATTLING

Chen's words may be a political ploy as local elections loom

due in Beijing later in August, and President George W. Bush will host Jiang at his Texas ranch in October. "The Sino-U.S. relationship is getting back on a more stable path, and [Chen and his advisers] feel uncomfortable about this," says Philip Yang, a professor at National Taiwan University in Taipei. "They want to tell Washington that we are the democratic government and have the right to exercise self-determination."

But the Taiwanese President may have miscalculated. The Taiwan Stock Exchange index plunged 7% in the two trading days after his Aug. 3 speech, largely because of fears of political instability, before recovering some ground. Chen's critics argue that Taiwan has no choice but to integrate further with the mainland, where Taiwanese companies are estimated to have invested more than \$50 billion. Mainland China has recently surpassed the U.S. as Taiwan's biggest export market. Now, progress on easing restrictions on direct links between Taiwan and the mainland could be slowed.

Privately, the Bush Administration was none too pleased with Chen's re-

marks, either. Like previous Administrations, the Bush White House supports a one-China policy, wants differences settled peacefully, and opposes provocative acts from either side. Although Bush has declared that he would do "whatever it takes" to defend Taiwan, even hard-liners such as Deputy Defense Secretary Paul D. Wolfowitz oppose independence for Taiwan.

So what now to expect from China and Taiwan? One indicator of China's fury will be its annual summer military exercises, which start in late August. These could be ratcheted up in force to send a signal of displeasure over Chen's latest moves. If the exercises get too threatening, that could send Asian markets into paroxysms—just when the region's bourses are giving up gains from earlier this year. One wild card is the current struggle among top Chinese leaders over who, if anyone, will succeed President Jiang Zemin as general secretary of the Communist Party at this autumn's Party Congress.

Chen may have timed his remarks to take advantage of that power struggle: Cadres maneuvering for position may be slower to react to the pesky Taiwanese than a unified Chinese leadership. As for a referendum on independence, analysts say it's unlikely to happen before the next presidential vote in two years. In politics, that's an eternity. But if Chen's pronouncements win his party big gains in December, Beijing may consider such a victory another provocation—and take provocative steps of its own.

By Bruce Einhorn in Taipei, Dexter Roberts in Beijing, and Stan Crock in Washington

Beijing. "Chen has just taken over [party] chairmanship, and he wants to fine-tune his cross-strait position." Chen may also have been sending a message to Washington not to back away from its support of Taiwan. His gambit comes at a time when the Bush Administration is trying to ease tensions with China, especially since the U.S. is anxious to avoid Chinese opposition to military moves against Iraq. Deputy Secretary of State Richard L. Armitage is

h pro-labor and pro-human rights Democrats. And it is backed up by U.S. China experts. Several published anti-China books, while critical of the new, congressional-led U.S.-China Security Review Commission. Its first annual report warned that if the U.S. is mishandled, China could pose a significant economic and security threat to our country."

One of the coalition is Senator Byrd (D-W. Va.), the powerman of the Senate Appropriations Committee. He

China **IN SEASON**
Some authors are stoking the anti-China fire

vehicles for anti-China amendments. They're expected to demand greater disclosure by Chinese companies raising capital in the U.S. and tighter restrictions on high-tech exports to Beijing, which they fear could be used for military purposes. "Do we really want to arm China?" asks Michael A. Ledeen, the commission's vice-chairman and an

American Enterprise Institute scholar. "That seems to me to be a big mistake." A legislative drive could undermine Sino-U.S. ties just as President Jiang Zemin visits the U.S. in October.

How bad could relations get? The Administration is likely to fight draconian measures, but the debate alone over anti-China proposals can spark a negative reaction from Beijing. "The threat to Sino-U.S. relations, the threat to

world peace, doesn't lie in China but rather in [those] who have fabricated this China threat," Xie Feng, the Chinese embassy's spokesman in Washington, recently told reporters. If the anti-China crowd gets busy, Beijing may soon have tougher things to say.

By Stan Crock in Washington, with Dexter Roberts in Beijing





ECONOMICS

A CASE OF AMERICAN FLU

Asia, knocked for a loop, is jittery about a U.S. double dip

For the better part of this year, as U.S. stock markets reeled, investors started looking again to East Asia as an oasis of opportunity. Bourses in South Korea, Thailand, and Indonesia, fueled by buoyant domestic demand, surging exports, and improved financial sectors, were among the world's best performers. As booming China sucked in record imports, hope rose that Asia could rely on a powerful new economic engine. Even Japan began resembling a safe haven for global capital; the Nikkei average soared 21% between February and June.

But in short order, a stream of bad U.S. economic news has helped bring Asia's markets back to earth. Even though most U.S. economists doubt there will be a new recession, Asian investors are spooked by slowing U.S. growth and falling manufacturing orders and consumer confidence. Japan's Nikkei and Korea's KOSPI indexes have lost all of this year's gains.

And in Taiwan, where a new war of words between Beijing and the island's government (page 52) has raised anxieties, stocks are off 15% for the year. Hardest hit have been shares in exporters of electronics, steel, and auto parts. Shares of chip giant Taiwan Semiconductor Manufacturing Co., for example, have dropped by half, to \$1.37.

A new U.S. rally could push Asian stocks back up, but the point has been made: The region's economic fate remains heavily linked to the U.S. Exports to America account for 10% of Asia's gross domestic product, notes Morgan Stanley economist Andy Xie. Just as the U.S. tech crash threw Taiwan, Japan, and Singapore into recession in 2001, America's recovery helped boost the region's exports by 13% in this year's first half.

If the U.S. slips back into recession, Xie figures, projected growth in non-Japan Asia would fall from 5.8% next year, to 3.5%. Japan's recovery hopes would be dashed. Half of the 5.7% growth rate Japan posted in the first quarter came from exports. Already, its producers are stinging from the yen's 10% jump against the U.S. dollar. "Just when Japan's economy seemed to be getting some momentum, the yen has

strengthened, and that's quite worrying," laments Toyota Motor Co. President Fujio Cho.

Asian markets also remain pendent on foreign capital. U.S. investors account for one-third of funds in the Thai bourse—and most of \$3.5 billion yanked from Japan stocks since June. The Nikkei's plunge in turn compounds Japan's bank crisis, as equity losses undercut capital base of big banks. A U.S. double dip "could have some disastrous consequences," says HSBC Securities Inc. strategist Garry Evans.

Asia's strongest exporters hope the impact will be light. "The U.S. certainly seems to be surrounded by negative factors," says Honda Motor Co. North America Chairman Ken Amemiya. "But we still expect demand for autos to exceed 16 million units this year," a slight dip from

2001. Other companies are looking to neighboring markets. Samsung Electronics Co. says China, Japan, and other Asian nations now take 30% of its digital TVs, chips, and notebook computers—the same proportion as the U.S. "I think we can achieve our earlier projections, despite what's happening in the U.S.," says Senior Vice-President Chang Il Hyung. And China's imports from Taiwan leaped by 30% in June.

China is indeed an increasingly important customer: Imports from Asian neighbors are up 22% this year. But much of that is materials used in goods assembled in China and exported to the U.S. It will be years before China can fully make up for slack in American demand. That's especially true in information technology products, which account for 37% of Asia's exports. "If troubles persist through next year, everybody will be hit," says Park Hyeong Il, a general manager of Korea's LG Electronics.

If America's recovery remains on track, that's great news. But lacking solid evidence of that, expect investors to approach Asia with great caution.

By Brian Bremner in Tokyo, with Moon Ihlwan in Seoul and Dex Roberts in Beijing



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EUROPE

E-COMMERCE STARTS TO CLICK

At last, European customers are flocking to the Web

Philippe Estela has joined the Internet generation. The 35-year-old Paris marketing executive used to buy his train tickets through one of the simple but clunky Minitel terminals distributed to households by the French government in the 1980s. Now, he's a convert to the national railroad's Web site, where he can check schedules, book train and plane tickets, and even reserve rental cars and hotel rooms. "Minitel had become a dinosaur," says Estela. "The Web is a lot more practical, functional, and comfortable."

Estela is not alone. French rail—Société Nationale des Chemins de Fer Français (SNCF)—logged nearly 2 million visitors to its Web site in June, up 63% from a year earlier, and ticket sales in the first six months topped \$122 mil-

lion, 70% more than the first half of 2001. "The market is in full development. We're just trying to manage our growth," says Denis Wathier, director of SNCF's Net unit.

Did somebody say growth? Yes, indeed. This year, while the world's attention has been diverted by slumping stocks and telecom turmoil, 12.7 million new Net users have signed on in Europe's five largest nations—Britain, France, Germany, Italy, and Spain—says researcher Nielsen/NetRatings Inc. in London. That brings those countries' active Net population to 60 million, up 14% in just the past six months. By comparison, active users in the U.S. have held flat, at 105 million, over the same period. "There's been a lot of gloom and doom and a lot of bankruptcies, but consumers don't care," says Jaap Favier, an Internet analyst at Forrester Research Inc. in Amsterdam. "They're still flocking to the Net."

And, Europeans are spending more money online. Take Egg PLC of London, the leading online financial-services company in Europe. It added a record 205,000 customers in the second quarter, and more than doubled its operating income, to \$121 million. Europe's largest discount carrier, easyJet Airline Co., sold \$80 million more tickets online in the six months ended Mar. 31 than it did a year earlier.

American Net giants now see Europe as a growth opportunity. Microsoft Corp. has driven its MSN portal to the No. 1 position in Europe, with 119 million visits per month. Judy Gibbons, MSN's vice-president for Europe, the Middle East, and Africa, says MSN's regional revenues grew 27% in the year ended June 30.

Results have been even better at e-commerce giant Amazon.com Inc. Combined revenues for the company's four non-U.S. domains—Britain, France, Germany, and Japan—grew at more than 70% annually in each of the past three quarters, topping \$218 million, or 27% of Amazon's total, in the quarter ended June 30. Amazon's French traffic has nearly tripled in the past 12 months. Europe's love affair with the Net is only beginning.

By Andy Reinhardt, with Christina White Passariello, in Paris

THE EURO NET TICKS UP



CURRENCIES

A LUCKY BUCK, FOR NOW

The dollar's sudden strength doesn't look likely to last

Stomach-churning dips haven't been confined to the stock markets. Currency markets, too, have been giving investors a hair-raising ride. The dollar went into a nosedive against the euro—plunging 18% from mid-June to mid-July. Now the greenback has suddenly come back, rising 4%, to 97.4¢ to the euro on Aug. 7.

Why the turnabout? The dollar, analysts say, is benefiting from a number of short-term effects. Once those fade, some traders, watch out. "We think dollar downtrend is still in place," says Stephen Hull, currency strategist at Goldman, Sachs & Co. in London.

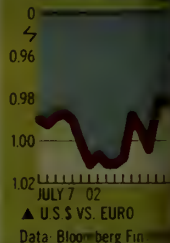
Like equities, the dollar was hit by the outlook for weaker U.S. growth and the U.S. corporate scandals. In the currency markets, like stocks, are pausing after a huge move. Speculators are taking profits and covering their short positions. Japanese intervention has also boosted the greenback, sending it from around 116

yen to about 121 over a two-week period. At the same time, U.S. investors worried about everything from possible war with Iraq to global growth prospects, are bringing money home, leading to big dollar purchases. A hope has surged that Federal Reserve Chairman Alan Greenspan will cut rates on Aug. 14, giving a boost to U.S. equities and the economy. "Investors think the cavalry is coming to save the day," says Rebecca Patterson, currency strategist at J.P. Morgan Chase & Co. in London. A Fed-led recovery would provide little reason to bet on the yen or euro.

How long will the dollar's strength last? Some traders are betting it will surge to 93¢ to the euro. Others are skeptical. Goldman Sachs, for instance, forecasts that record trade deficits will drive the dollar down again, to \$1.06 to the euro, within six months. This ride isn't over.

By Stanley Reed in London

DOLLAR COMEBACK



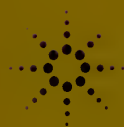
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RUSSIA

MONEY TO BURN... PUTIN

Tycoon Boris Berezovsky funds a smear campaign

Say this for the energetic Russian tycoon-turned-politician Boris Berezovsky: He's not one for half measures. Now living in Britain, he says he's planning to spend \$100 million of his fortune—which he pegs at \$1.5 billion to \$2 billion—on a political campaign to brand Russian President Vladimir V. Putin as a murderous dictator. “Putin is trying to build an authoritarian regime in Russia,” Berezovsky says. “I am using my financial resources to create an

really matter if Berezovsky is a saint or a sinner if what he is doing can encourage more democratic development in Russia,” says Blair A. Ruble, director of the Kennan Institute for Advanced Russian Studies in Washington.

Berezovsky's saga embodies the bizarre character of post-Soviet Russia. In Act One, he used his skills as a mathematician to get rich fast, was nearly killed by a car bomb, bankrolled Boris Yeltsin's 1996 presidential reelection, and created a business empire that stretched from TV network ORT to national airline Aeroflot. Then he became a player in the enfeebled Yeltsin's Kremlin, a kind of puppet master in an alcohol-saturated court.

The curtain came down after a sober ex-KGB colonel, Vladimir V. Putin, became President and told *businessmen* like Berezovsky to butt out of politics. Putin then pressured Berezovsky to sell pieces

has agreed to show it, so Berezovsky's new Liberal Russia political party is ranging for private screenings. Meanwhile, his New York-based International Foundation for Civil Liberties offers legal assistance to the kin of Russian sailors drowned in the Kursk submarine. Families may appeal a prosecutor's decision that found no criminal culpability in the Kursk sinking.

The Kremlin belittles Berezovsky's efforts. “He is trying to avoid the destiny of a forgotten tycoon,” says a Putin aide. An FSB spokesman says: “Berezovsky's stupid accusations have nothing to do with reality.” But even though Berezovsky remains highly unpopular in Russia, he is tapping deep suspicion. More than 40% of Russians say it is likely that the secret services are linked to the bombings. “He sensed the dangerous aspects of Putin's activities earlier than anyone else,” says Alexei

FAST STUDY

Act I After the Soviet Union's collapse, Berezovsky, a mathematician born in Moscow in 1946, makes millions on various interests including car-dealership chain Logavaz.

KREMLIN INSIDER

Act II Helps Boris Yeltsin get reelected in 1996 and then pulls strings inside the Kremlin itself.

OLIGARCH IN EXILE

Act III In November, 2000, he flees to London rather than face prosecutors' questions on his role in alleged embezzlement at Aeroflot—a matter he views as politically inspired by Putin. Now plots \$100 million political campaign to oust Putin.

Data: BusinessWeek

BEREZOVSKY'S RISE AND FALL, IN THREE ACTS



opposition.” He outlines the project between bites of penne pasta at Sartoria on London's Savile Row, just down the street from his office. As was his habit in Moscow, he's accompanied by bodyguards. He's sipping an \$80 bottle of Chardonnay; they're on apple juice.

For Berezovsky, Russia's celebrity oligarch, this new venture amounts to Act Three of a turbulent odyssey. His get-Putin plan seems improbable, but it should not be dismissed. After all, a public reared on Soviet lies is vulnerable to Berezovsky's core message that an arrogant state is capable of heinous actions. And democracy-building is typically a messy process in which muckrakers, even rogues, for their own reasons, challenge the state. “It doesn't

of his empire. Berezovsky claims to have lost \$800 million in the process. Stung, he became a Putin critic—and found himself wanted by prosecutors probing an alleged embezzlement at Aeroflot. In late 2000, he fled to Britain.

Thus began Act Three: the oligarch in exile. His anti-Putin campaign goes for the jugular: Its centerpiece is a documentary alleging that Russian FSB security service officials, with Putin's likely knowledge, were behind a 1999 series of apartment bombings in Moscow. Offering no hard proof, the film, titled *Assassination of Russia*, insinuates that Putin used the bombings, widely blamed on Chechen terrorists, as a pretext for a war against Chechnya, a conflict that established his can-do credentials. No Russian TV station

monov, president of the Moscow-based Glasnost Defense Foundation.

Simonov's group has a grant from Berezovsky to provide legal assistance to journalists such as Grigory Pasko, convicted of treason for taking notes at a meeting of naval commanders. “I see in him very good intentions,” says Yelena Bonner, the widow of dissident Andrei Sakharov and a fierce critic herself of Putin. She accepted \$3 million from Berezovsky's foundation for the Sakharov Museum in Moscow. A Berezovsky aide admits some anti-Putin activists spent millions to spend, Berezovsky has stayed in power. So keep to your seat: Boris Berezovsky, Act Three, is just beginning.

By Paul Starobin in London

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BRITAIN

NOW, HIS GROWL GRABS ATTENTION

Terry Smith's blunt analyses have been right on the money

His firm once labeled one of Europe's biggest media companies "Eurotrash." He estimates that Rupert Murdoch's British Sky Broadcasting PLC is really worth only a third of its market cap. And he says corporate executives aren't worth an analyst's time. Meet Terry Smith, one of Europe's brashest and most irreverent stockbrokers. During the long bull market of the 1990s, Smith, an inveterate bear, was frequently dismissed as "mad." Yet in these dark, bearish days, Smith—now chief executive of a small, independent London brokerage firm Collins Stewart Holdings PLC—is taken very seriously indeed.

Smith's calls have gotten so much attention that he has attracted a big following among U.S. hedge-fund managers looking for stocks to short. "We have all known Terry for a very long time and have a high regard for his objectivity," says John R. Hickling, a partner at Liberty Square Asset Management LLC in Boston. "He approaches everything with a healthy skepticism."

That's an understatement. Smith was among the first analysts to conclude that former Vivendi Universal CEO Jean-Marie Messier was wasting tens of billions in capital by setting himself up as

a transatlantic media mogul. "The economics of the movie industry seems to represent the ultimate triumph of hope over experience," he said in a report in June, 2000, commenting on Vivendi's purchase of Seagram and its Universal Studios. A year later, Collins Stewart skewered Vivendi again with a commentary headlined: "Vivendi: Dangerous Eurotrash."

Vodafone Group has also come under the Smith lash. In January, 2000, Collins Stewart calculated that the cell-phone operator would get a far better return investing in high-grade corporate bonds than spending \$157 billion taking over German rival Mannesmann. And it was right, judging by the 75% fall in Vodafone's share price since then. Politicians and regulators, Smith says, will never succeed in protecting investors. Instead, companies "need to be judged by an adversarial system—they need someone like me to poke them with a stick."

And poke he does. Smith scrutinizes company reports for telltale accounting tricks and crunches the numbers to produce what he calls "cash-flow return on investment." He says this is useful in judging whether a company is spending capital wisely. Smith also figures what a company is worth from a present-value analysis of cash flow from existing assets and future investments. Right now, this is telling him that Ericsson, the big Swedish phone-equipment maker, should be valued at about a fifth of its already bombed-out share

SMITH: Companies "need someone like me to poke them with a stick"

price. And he pegs the value of BS at \$3.65 billion—a quarter of its current market capitalization. Smith's planation: BSKyB isn't a growth company anymore but a mature business.

Companies sometimes lash back. Smith had a bitter public feud with Vivendi when he said it was destroying value. Smith's execs criticize Collins Stewart for letting them preview its research, the way most investment banks do. But Smith sees little point in debating his views with CEOs. "They often don't know what is going on in the business," he says.

"and, as we found they lie."

A 49-year-old product of London's East

Smith has

courted controversy. He

shocked the market by publishing a

caustic note on the prospects of

clays PLC while he was working for

investment-bank subsidiary, BZW.

he was fired by the securities arm of

old Union Bank of Switzerland in

when he refused to halt publication of

book he wrote on *Accounting for Growth* that used some of

SMITH'S CURRENT PICKS AND PANS

SELL

BRITISH SKY BROADCASTING Modest returns don't justify its high price

VODAFONE Mature, low-return business

NOKIA Diminishing returns

RYANAIR Increasingly crowded field

BUY

B.A.T. Steady, high returns

NOVARTIS Reliable and relatively cheap

SWISSCOM Plain-vanilla telecom

OTE HELLENIC Value-priced telecom

Data: Collins Stewart, BW

clients as examples of how companies manipulate their numbers. He started Collins Stewart in 1992 and became chief executive in 2000. Last year, Collins Stewart reported \$53 million in operating profits on revenues of \$154 million.

Smith remains pessimistic about equity markets, saying they remind him of the early 1970s. He thinks the Standard & Poor's 500-stock index may fall 10% more, while London's benchmark FT 100 index may have 10% to 15% further to drop. He does have buy ratings on some stocks, but he thinks most small investors should stay out of the market unless they have a very long-term view. "We had excesses in the 1990s, so we will have excesses on the downside as well," he says. But as someone running a City of London firm, he admits he wouldn't mind being wrong.

By Stanley Reed in London

WHY DIDN'T I KNOW ANYONE IN THE ELEVATOR?
 WHAT BUSINESS ARE WE IN, ANYWAY?
 IF WE OUTSOURCED MORE THINGS, WE COULD BE MORE...
 FOCUSED. I'M ALL ABOUT FOCUS.
 UNDER HOW PRODUCTION MY CABIN...
 I WANT A STATION THAT PLAYS MORE TALK LESS ROCK.
 WHY DIDN'T I NOON, AND NO THE LAST GUY DECIDE TO OUTSOURCE.
 I NEED A NEW PHOTO FOR THE ANNUAL REPORT.

STILL I CAN'T BELIEVE I WAS NOMINATED FOR CEO OF THE YEAR.
 I WISH I COULD KNOW THE CORN THAT SPIN ON THAT INTERNET AUCTION IS MINE.
 I SHOULD HAVE BEEN A WARLORD MAN. THESE SHOES ARE COMFY...
 TIME TO NOD AND LOOK PENSIVE...
 SHOULD I RENEW MY SEASON TICKETS?
 IF THERE'S NO SMOKING IN THE BUILDING, HOW COME IT REEKS OF CIGARS?
 COULD I KEEP STEVE FROM LEAVING AS WELL?

FORGOT TO CALL MOM AGAIN.
 HOW ABOUT THIS FOR A DEPARTMENT SLOGAN: I.T. IS "ITI" THAT'S CLEVER.
 ARE WE DONE YET? I'M GOING SPELLUNKING.
 WHAT DID THIS COMPANY EVER DO BEFORE THE I.T. DEPARTMENT?
 ONLY 5,611 EXPENSE REPORTS. MUST DO EXPENSE REPORTS.
 I WONDER IF I COULD KEEP JIM FROM QUITTING.
 ON BEHALF OF EVERYONE IN I.T., I'D LIKE TO KISS THE PERSON WHO SUGGESTED OUTSOURCING OUR HR STUFF.

KE RACKS THE LOBBY - WHY ARE WE NOT TALKING ABOUT THAT?
 3 MORE MINUTES, AND THE LIZZIE HUMMEL SERIES ON THAT INTERNET AUCTION IS MINE.
 I SHOULD HAVE BEEN A WARLORD MAN. THESE SHOES ARE COMFY...
 TIME TO NOD AND LOOK PENSIVE...
 SHOULD I RENEW MY SEASON TICKETS?
 IF THERE'S NO SMOKING IN THE BUILDING, HOW COME IT REEKS OF CIGARS?
 COULD I KEEP STEVE FROM LEAVING AS WELL?

IF I PUT A MAN ON THE MOON, SURELY HE CAN OUTSOURCE BENEFITS, RIGHT?

THOSE GARDENING AWARDS WERE TOTALLY RIGGED.
 IS FLAG DAY A BUSINESS HOLIDAY?
 MAYBE THE INTERNS CAN GET US SOME LUNCH.
 MMMM. FRESH COFFEE.
 HOW WILL SOMEONE ELSE FIGURE THIS PLACE OUT? WE CAN'T EVEN FIGURE THIS PLACE OUT?
 I WILL TAKE A VACATION THIS YEAR. I WILL TAKE A VACATION THIS YEAR.
 I WILL TAKE A...
 IT'S BEEN A WHILE SINCE ANYONE HAS COME OUT WITH A NEW CANDY BAR. I WONDER WHAT'S WRONG.
 I'VE NEVER OUTSOURCED BEFORE. BUT THEN, I'D NEVER KARAOKEED BEFORE AND NOW, I ROCK.
 I NEED TO TALK WITH GREG ABOUT HIS FUTURE HERE. MAYBE TOMORROW.
 I HOPE THESE PEOPLE ARE AROUND WHEN IT'S TIME TO IMPLEMENT THINGS.
 I WAS THE ONE WHO SUGGESTED OUTSOURCING, NOT TED. WHY DON'T PEOPLE REMEMBER THAT?
 I FORGOT TO TELL THE DRY CLEANERS "LIGHT STARCH."
 I SHOULD HAVE BEEN A DRUM MAJOR-ETTE.
 IT'S NOON AND NO ONE SAID NO TO MY NAILS.
 I DON'T WANT TO KNOW WHAT THAT ARTIST IS DOING.
 WHAT'S AN 8-LETTER WORD FOR A LOT?

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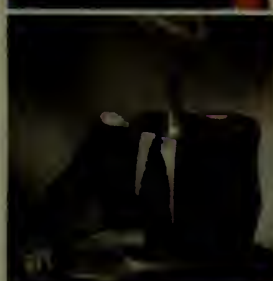
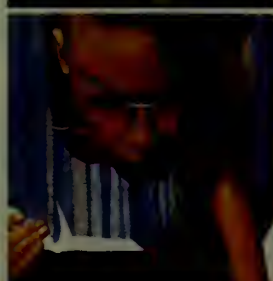
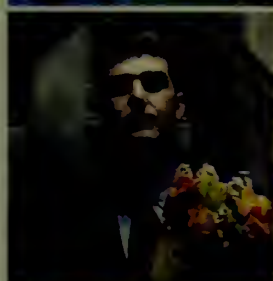
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25 Ideas for a Changing World

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BusinessWeek

Why the World Needs New

America needs to get its groove back. In this era of change—in government, the markets, corporate behavior, and the management of information—here are 25 ideas to help set us on the right path

W

By Bruce Nussbaum

It appears to be waiting to exhale this summer, holding our breath, uncertain of what comes next. As a nation, we seem to have lost our confidence, our usual risk-taking swagger. What's going on?

The plain truth is that a once-in-a-century confluence of events is turning our world upside down. The unexpected bursting of the tech bubble, the unnerving terrorism of September 11, the shocking revelations of corporate corruption, and the dramatic decline in equities and personal wealth are transforming how we have lived for the past two decades. Not one but many institutions are changing before our eyes, and we don't yet know exactly how or what final form they will take.

In these tumultuous times, ideas have never been more needed or more important. In the '90s, ideas shaped our worlds of entertainment, communication, and finance. In this more uncertain period, ideas have greater gravitas. We need new notions on how to enhance security while preserving privacy and how to regain investor trust without choking off markets and entrepreneurialism. We need to think differently about the ethics of misusing information when so much of our children's education and our retirement depends on the reliability of financial data. We need ideas on how to get back on a path to prosperity.

The best ideas will come from those who understand how our institutions are changing. Take the shifting role of our federal government. Since the election of Ronald Reagan as President in 1980, government has increasingly been seen as a problem, not a solution, an obstacle not a facilitator, a bureaucracy that intruded into our personal and economic lives. Yet in the blink of an eye, all that has changed. Government, and our relationship to it, have been transformed. Terrorism from abroad and home-grown corporate crime are renewing Wash-

ington's role as protector of the people and watchdog of the economy.

We need new ideas on deciding just how big government should get and how intrusive it should be. What should be the trade-off between retaining our precious liberties and securing our country against foreign threats? Silicon Valley entrepreneurs and product designers are rushing out innovations that will allow smooth travel through airports, safe shipping of goods through harbors, and thorough screening of terrorists and terror threats. If these new ideas are successful, Americans may be able to protect their civil liberties and keep their economy open while making the country safer. If they fail, we may enter a darker era.

One Orwellian plan proposed by the Justice Dept., called TIPS, would enlist millions of Americans to spy on their neighbors and tip off the government on potential terrorists—a disturbing concept.

Corporate America is also undergoing major changes that will require new ideas to ensure success. How can companies, led by celebrity CEOs who are paid huge sums to focus on stock price, morph into institutions that emphasize trust, integrity, and accountability? One idea: have



Thinking

at arm's length with independent directors when they're used to controlling them? What happens when the jobs of CEO and chairman are separated, as now seems possible, and the two have a more adversarial relationship?

The stock market is undergoing major change as well. Americans feel betrayed by the market precisely because they believed in it so much over the past two decades. Many accepted the idea that regulation was, by and large, bad. Competition and self-policing would produce the best results, right? In the end, they didn't. Loose accounting procedures were bent beyond belief, and self-policing turned into self-interest and self-aggrandizement. Investors lost confidence in the credibility of an entire generation of corporate leaders and the accounting, legal, and Wall Street professionals who were supposed to protect shareholders. We now look to government to step in, punish wrongdoers, and reregulate the markets to ensure transparency, fairness, and integrity.

We need to decide how far to go. The danger is that in trying to restore confidence to investors, the country chokes off its capitalist "animal spirits." Just as we need new ideas on rebalancing privacy and security to maintain our liberty, we need to think about how best to rebalance oversight and market openness to maximize economic growth. These are immense issues.

Fortunately, Americans like new ideas, and they like to innovate. This attitude will carry us through these troubled times. We can reinvent our hospitals for better care. We can remake our schools to get 3- and 4-year-old inner-city kids into catch-up programs. And we can revalue immigrants, welcoming them as others do not, as economic benefactors.

We need new ideas to calm us, guide us, and restore us. We need to become comfortable taking risks again. We need to get back our optimism, even a little swagger. Here are 25 insightful and provocative ideas that go a long way toward that goal. Read them and be inspired. ■

CEOs remake their companies into paragons of corporate responsibility, luring investors via their virtue. Indeed, the idea of making a reputation for corporate responsibility an investable theme is one of the new ideas in Corporate America today. We need new ideas on how to reshape corporate structures well. Many CEOs have long appointed cronies to boards. Today, the New York Stock Exchange and Nasdaq are proposing that independent directors take charge of boards. How will CEOs learn to negotiate

After Enron: The Ideal Corporation

CORPORATION

1

Following the abuses of the '90s, executives are learning that trust, integrity, and fairness do matter—and are crucial to the bottom line

E

By John A. Byrne

Every summer for the past 10 years, Jack Stack has been going to Massachusetts Institute of Technology's Sloan School of Management to speak with young chief executives about the ideals and values of the engine manufacturing company he helped to make a management paragon. In the late 1980s, Stack's Springfield ReManufacturing Corp. emerged as a model for how management and labor could successfully work together in a culture of trust and ownership. Thousands of managers flocked to his company to hear his ideas while others gathered to hear him during his annual trek to MIT for its Birthing of Giants program for new CEOs.

But as the dot-com era took hold in the late 1990s, Stack saw a change in the attitudes of the business leaders who showed up at MIT. They seemed far more ambitious for themselves than for their companies. They were building organizations to flip, not to last. They were more interested in the value of their stockholdings than the profits of their companies. They told him his ideas for tapping into the enthusiasm, intelligence, and creativity of working people were antiquated. And they said he was out of touch.

Stack says that even he began to think of himself as a dinosaur. "So many young CEOs were mesmerized by getting a \$1 million or \$2 million pop, selling out, and then getting out of town," he says. "They forgot that business is all about values."

Suddenly, leaders like Stack—peo-

ple who take concepts like ethics and fairness seriously—are back in vogue in a big way. In the post-Enron, post-bubble world, there is a yearning for corporate values that reach deeper than the size of the chief executive's check or even the latest stock price. Trust, integrity, and fairness do matter, and they are crucial to the bottom line. The corporate leaders and entrepreneurs who somehow found that are now paying the price in a down market roiled by a loss of investor confidence. "The chasm that separates individuals and organizations is marked by frustration, distrust, disappointment, and even rage," Shoshana Zuboff, a Harvard Business School professor and co-author of a new book called *The Support Economy*.

The realization that many companies played fast and loose with accounting rules and ethical standards in the 1990s is leading to a reevaluation of corporate goals and purpose. Zuboff and many other business observers are optimistic that the abuses now dominating the headlines may result in healthy changes in the post-Enron modern corporation. What's emerging is a new model of the ideal corporation.

Business leaders say corporations will likely become far more transparent—not only for investors, but also for employees, customers, and suppliers. The single-minded focus on "shareholder value," which measured performance as the sole basis of stock price, will diminish. Instead, companies will elevate the interests of employees, customers, and their communities. Executive pay, which clearly soared out of control in the past two decades, is already undergoing a reassessment and will likely

TRUST Giving employees an ownership stake can build an unusual level of mutual respect

Illustrations by
Brian Cronin





TRANSPARENCY Making the inner workings visible to all will put pressure on companies to clean up their acts

fall back in an effort to create a sense of fairness. And corporate cultures will change in a way that puts greater emphasis on integrity and trust.

The new agenda, say management observers, will require greater investment in financial systems, ethics training, and corporate governance. It may also demand a resetting of expectations so that investors are more realistic about the returns a company can legitimately and consistently achieve in highly competitive markets. Growth rates of 20% and up, even in technologically-driven industries, are likely to be a thing of the past.

In the anything-goes 1990s, too many companies allowed performance to be disconnected from meaningful corporate values. "A lot of companies simply looked at performance in assessing their leaders," says Larry Johnston, CEO of Albertson's Inc., the food retailer. "There have to be two dimensions to leadership: per-

formance and values. You can't have without the other."

This and other changes will be driven less by the threat of government intervention and more by the stigma of being branded an unethical enterprise. That's why the government's newfound zeal to indict individuals and even companies wields such power, regardless of how cases are resolved. "Social sanctions can eclipse the law in imposing penalties for misconduct and mischief," says Richard T. Pascale, a management authority and author of *Surfing the Edge of Chaos*. "The corporation of the future has to take about this new development as an increasingly formidable factor to be reckoned with."

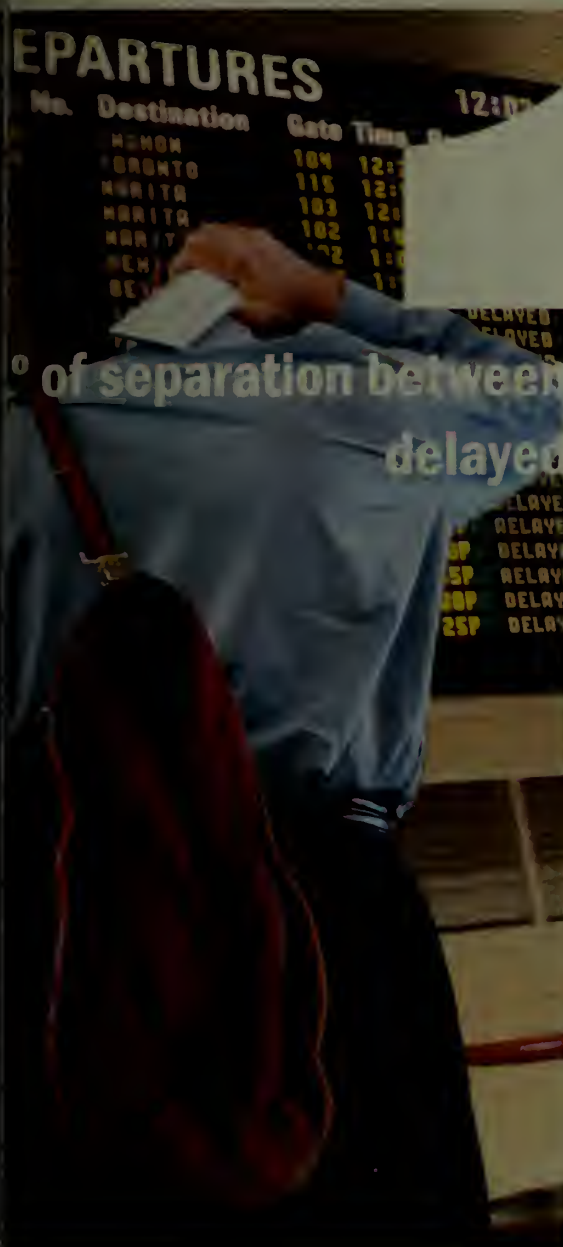
That's a change from the 1990s, when pressure from Wall Street and the dot-com mania led to much of the corporate exodus. During those years, when Stack found ideas decidedly out of favor, he stuck with the "open-book management" culture that had made him something of a celebrity years earlier. By sharing all of the company's financials with all employees and giving them an ownership stake in the company, Stack had built a level of mutual trust and respect unusual in business.

There were other organizations that clung to similar beliefs, from Southwest Airlines Co. to Harley-Davidson. "We stayed close together because we knew the dot-com model didn't have legs," says Stack. "But many of us wondered if the world would get back to companies with real values." Right now, Stack's ideas about leadership and management are resonating with many who feel disillusioned about business.

If there's one change that nearly everyone foresees today, it's a move to make the corporation far more transparent. That's obvious when it comes to investors

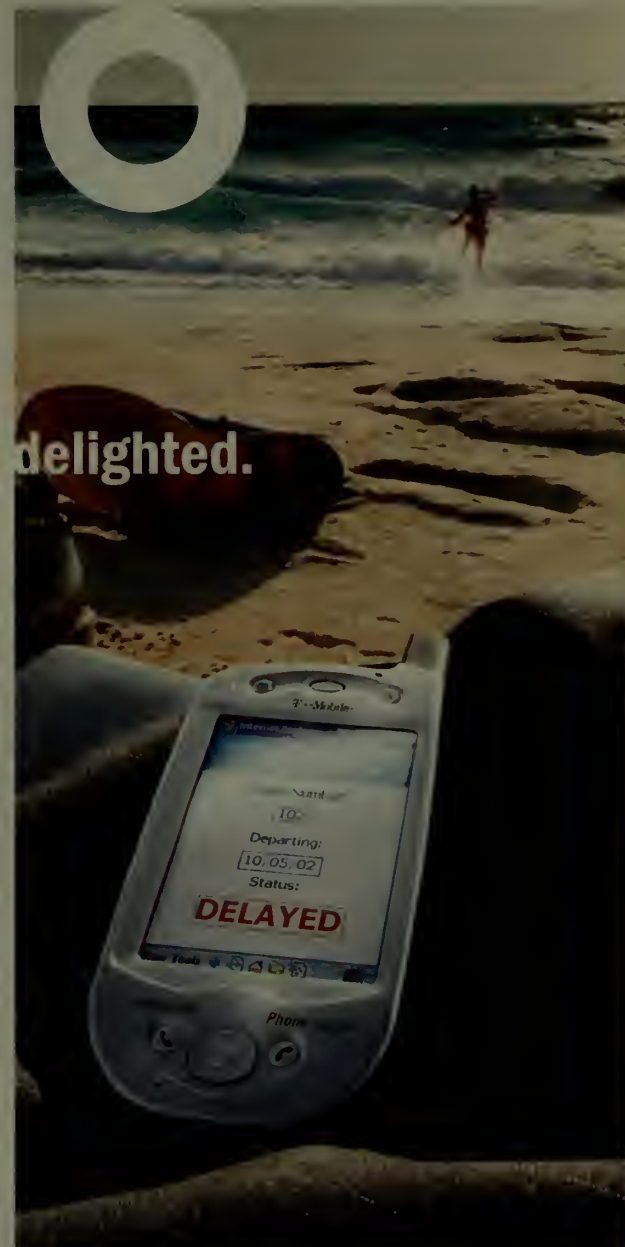
who are demanding truth in the numbers and clarity in disclosure. But it's also important to employees if they're to have a true sense of ownership in their company's affairs. At Stack's company, there are weekly huddles with workers and managers, prominent scorecards on factory walls charting work progress, and a going emphasis by managers on building a company and not just a product. Workers undergo training so they can understand the numbers on a balance sheet and an income statement.

That need to make the inner workings of the corporation visible to all constituencies is expected to drive lots of change. "In so many senses, there aren't going to be many secrets in business anymore," believes consultant James Champy, chairman of Perot Systems Corp. consulting practice. "Even customers are calling for it today. Wal-Mart Stores Inc. wants to know what the costs of its suppliers are." The end result: It will put greater pressure on cor-



° of separation between
delayed

and delighted.



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Tools for the New Work



ACCOUNTABILITY An open culture will enable employees to more easily report ethical lapses and unfair practices

panies to clean up their management processes and become more efficient, and it will cause yet another re-examination of less-profitable businesses.

Corporate cultures, which in many cases veered out of control in the 1990s by emphasizing profit at any cost, are also in for an overhaul. More than anything else, those beliefs and attitudes are set by the top execs. The values they espouse, the incentives they put in place, and their own

behavior provide the cues for the rest of the organization. "The CEO sets the tone for an organization's culture," says Alfred P. West Jr., founder and CEO of financial-services firm SEI Investments Co., which operates the back-office services for mutual funds and bank trust departments.

Like Stack, West is a rather uncommon CEO. As the company's founder, he does not take stock options and pays himself a sober \$660,000 a year. Rather than a spacious corner office, he has the same open-plan office space and desk as anyone else at company headquarters in Oaks, Pa., and he shuns the perks that are commonly demanded in the executive contract. Why? "If you separate yourself from everybody else with corporate aircraft and enormous stock options, your employees are going to get the wrong message," says West.

To make sure they get the right message, West spends a lot of time banging home his vision of the company to the people who work there. His goal of building an open culture of integrity, ownership, and accountability is a harbinger for what organizations will look like in the future. "We tell our employees a lot about where the company is going. We overcommunicate the vision and the strategy and continually reinforce the culture." Companies are also using that kind of openness to make it easier for their employees to report ethical lapses and unfair practices with whistle-blower hotlines and open procedures for

airing grievances. And to give employees an incentive to use all that newly available information, many companies will help them acquire stakes through discounted stock plans. And stock options are in for a revamping—longer vesting periods and perhaps mandatory holding periods as well.

Through the current dark period, there's reason for optimism. Harvard's Zuboff notes that capitalism has avoided devastating crises because it is a robust economic system that changes and adapts. The unprecedented economic expansion of the 1990s was widely seen as the triumph of managerial capitalism. Highly motivated business people used public capital to bring to life creative ideas and concepts for companies and products. Corporate ownership was dispersed among many shareholders, control and the lion's share of rewards were concentrated at the top of the managerial hierarchy—whether the company was a startup or an incumbent.

The next stage, believes Zuboff, will be something she calls "distributed capitalism," in which ownership will be more widely spread and organizations will be as responsive to their employees and communities as they have been to their shareholders in the past decade.

Wishful thinking? Perhaps. But the first step of the post-Enron corporation is to acknowledge that a company's viability now depends less on making the numbers at any cost and more on the integrity and trustworthiness of its practices. In the future, leadership that preaches this new ethos and reinforces it through value-driven cultures will be far more likely to reap the rewards of the changing marketplace.



PAY Executive compensation, clearly out of control, is likely to fall back in an effort to create a sense of fairness



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The Mea Culpa



The instinctive reaction of executives in times of scandal is to deny, deny, deny—then clam up. In many cases, the smarter response is a heartfelt apology

CORPORATION

By Mike France

Investors have lost trillions, popular anger at Big Business is at the highest level since the Great Depression, and foreigners are questioning the vitality of American capitalism. What do the executives who got us into this mess have to say for themselves?

Jeffrey K. Skilling is "immensely proud" of what he accomplished at Enron. Marc Shapiro, chairman of J.P. Morgan Chase, insists his bank's transactions with the Houston

ergy giant were en-
ly "appropri-

"Duke Ener-
round-trip
er trades were
ll within market
s," says CEO
es Donnell, while
tha Stewart calls
der-trading allega-
s "ridiculous" and
ps lettuce.

With corporate credibility sinking to new lows, managers in the flight are stonewalling, lying, and taking the high. Hardly any of them admitted they did anything wrong or expressed a mote of remorse. And it's only making things

responsibility for their misdeeds, there's little reason to believe the deeds won't be repeated. Why are so many execs acting like corporate villains from central casting? Probably because lawyers are telling them to do so. Apologists are the functional equivalent of guilty as charged—giant, wrapped gifts for opposing prosecutors, regulators, and plaintiffs' attorneys. So in-house counsel have traditionally advised clients in hot water to play legal hardball; think Tobacco or Exxon Valdez. "The first reaction in many companies when there's a big legal

feeding frenzy is to hunker down and fight," says New York litigator Philip K. Howard, author of the best-selling *The Death of Common Sense*. "A lot of times, that just gets them into a bigger mess."

Is there a way out of this trap? Do companies always have to look unrepentant when scandal breaks? Maybe not. A growing number of defense attorneys, law professors, and PR pros argue that CEOs should try a different approach when scandal breaks: going down on bended knee and saying that they are sorry. New academic research indicates that the goodwill generated by mea culpas could more than make up for their legal costs. State legislatures, meanwhile, are quietly passing laws that encourage contrition by making apologies inadmissible as evidence against those making them.

Nobody keeps statistics on whether the level of

corporate remorse is rising or falling. But there have been several high-profile mea culpas in recent months. After embarrassing e-mail messages came to light indicating Merrill Lynch analysts had told investors to buy stocks that they privately viewed as dogs, the firm issued a public apology in May. And both Ford and Firestone last year offered expressions of sympathy to rollover victim Donna Bailey.

Apologies can have surprising power when they are

delivered well. On July 12, for instance, Joette Schmidt, vice-president for customer service at America West Airlines Inc. went on the *Today Show* to ask the forgiveness of Sheryl Cole, a passenger who had been thrown off a flight for joking about the company's recent drunken-pilot episode. Ignoring interviewer Matt Lauer's invitation to defend the airline's conduct, Schmidt declared: "I'm here primarily to apologize to Ms. Cole. We overreacted." The victim, who had spent the first minute of the segment tearing into America West, was caught off guard. "I appreciate the apology," Cole responded. "I'm sympathetic to America West right

“To be sure, this has been a tragedy yet your valiant resolve, your spirit and your quiet dignity are an inspiration to us all”

**EXCERPT FROM A
LETTER TO ROLLOVER
VICTIM DONNA BAILEY
FROM BRIDGESTONE/
FIRESTONE CEO
JOHN T. LAMPE**

John T. Lumspe
Chairman,
Chief Executive Officer
and President

Dear Mrs. Bailey,

There is nothing any of us at Easton
can say or do to return to you what
you and your family have lost. All we
can do is to try to help you take care
of your needs and those of your family.
I am hopeful that with this assistance
you can begin to do so.

Yours truly,
The Trustees

To be sure, this has been a terribly
upset your violent, restless, your, spirit
and your quiet dignity are an inspiration
to us all.

So the
 left your wallet
 and your quiet dignity are
 to us all.

Please know that I carry you and your
 family with me in my thoughts, and
 that I have my best regards and my
 respects.

Sincerely,
 (John) [Signature]

Sincerely,
John S. Sargent

now. I know they're going through a tough time."

Of course, it isn't always so easy. Kenneth L. Lay can't simply pull up a seat beside Oprah, offer up a confession, and make investors, regulators, and prosecutors suddenly forget about the Enron disaster. But in many situations, in which essentially law-abiding companies have made out-of-character blunders, apology has great underutilized potential to help win public forgiveness. At a time when Corporate America is desperate to regain investor trust, it could be a valuable tool.

One insight offered by the new academic research is that companies may be overestimating the costs of apologies and underestimating their benefits. For one thing, juries weigh the fact that a company has faced up to its problems when assessing punitive damages. More important, apologies can defuse victims' anger. Some evidence suggests that people may be just as interested in apologies as they are in money. In one 1994 study of British medical malpractice patients, 37% said they wouldn't have brought suit had the doctor provided them with an explanation and an apology.

And ever since 1987, the Veterans Affairs Medical Center in Lexington, Ky., has had a policy of apologizing to malpractice victims—regardless of the legal consequences. The medical

profession hasn't rushed to follow this example. But a 1999 follow-up study found that the hospital was in the lowest quartile in claims payments among 36 comparable institutions.

These examples might not be enough to persuade a CEO with plaintiffs' lawyers on his tail to issue an apology. But one development that could make a difference is the new crop of laws making mea culpas inadmissible in court. They

passed such legislation

1999, California did so

2000, and Florida

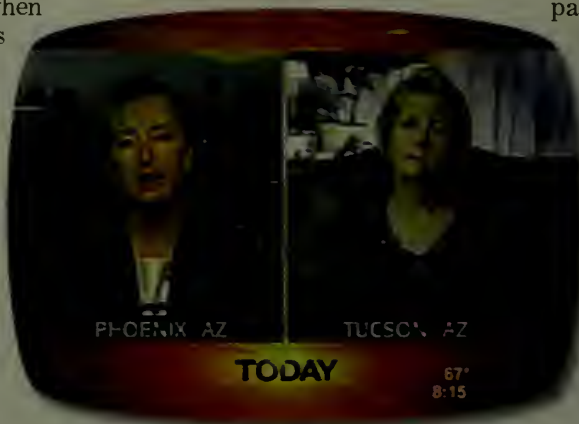
allowed suit last year

Similar bills are pending in eight states.

The details differ, but the laws generally prevent expressions of sympathy from being used as evidence of fault after an accident. They do not, however, apply to expressions of fault. So the statement "I'm sorry your son died in the car crash" would not be admissible to a jury, while "I'm sorry your son died because of our car's defective brakes," would be.

One criticism of the laws is that they encourage wimpy apologies. While an expression of sympathy is nice, it means much more when it's accompanied by an acknowledgment of fault. In fact, a company that merely offers condolences without admitting that it has done anything wrong can come across as insincere. This problem already plays out in many attempts at public contrition. Consider Merrill Lynch. On close examination, the company expressed only "regret that there were instances in which certain of our Internet-sector research analysts expressed views that at certain points may have appeared inconsistent with Merrill Lynch's published recommendations." In other words, Merrill apologized for its analysts' e-mail—not its own less-than-candid stock recommendations. The company declined to comment on its apology.

This trick may have helped reduce the firm's legal liability, but it did little to win over the public. Unlike America West's apology, Merrill's mea culpa won almost no goodwill. And that wasn't the only problem. The most important audience for apologies, in many cases, isn't just the outside world. It is also a company's own employees. There's no better way for CEOs to tell underlings they are serious about changing a company's culture than with a sincere apology—one indicating that top execs understand the rules they broke and that they intend to abide by them in the future. Merrill's mea culpa sent just the opposite message: that the company is talking one game but playing another. That's the wrong signal to be sending these days.



"I'm here primarily to apologize to Ms. Cole. We overreacted"

AMERICA WEST V-P JOETTE SCHMIDT (LEFT) ON NATIONAL TV, TO A PASSENGER THROWN OFF A FLIGHT FOR CRACKING A JOKE

The Hardest Thing to Do

After companies mess up, one way to win public forgiveness is with an apology. But it can be perilous and it's hard to do right. Here's how mea culpas should be delivered:

QUICKLY The longer a company delays in acknowledging wrongdoing, the less sincere the apology seems. Say it soon—before the words seem too calculated.

AUTHORITATIVELY Don't delegate this critical task to a faceless public-relations manager. The apology should come from the top: the CEO or the chairman of the board.

CLEARLY State the law or regulation or ethical guideline that the company has breached in clear terms—and affirm its continued importance.

BRAVELY Don't weigh down the apology with legalese, loopholes, contingencies, and clauses. Speak in plain, honest English and accept the consequences.

Data: BusinessWeek



(ATTENTION)



(ATTENTIVE)



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Crimes Against the Information Age

ECONOMY

3

In this era, the price of bad data can be disaster. When a company lies or inflates its numbers, everyone suffers: Investors, the financial markets, and even competitors

H

By Michael
J. Mandel

ere's a simple observation: Many of the leading figures in today's corporate scandals, such as Kenneth Lay and Jeffrey Skilling of Enron, Bernard Ebbers of WorldCom, and Gary Winnick of Global Crossing, may never be convicted of a single crime. They got approval from their boards of directors and accountants for most of their actions. And while their financing and accounting techniques were aggressive to an extreme, they may not rise to the level needed to put the executives in jail.

But that's no solace to investors, who discovered all too late that those companies and a slew of others were far weaker than they believed: Debt levels were higher, true revenues were lower, and prospects for future growth far less optimistic than the executives had made them seem at the time.

It may turn out that these executives were not guilty legally. Nevertheless, they committed serious offenses against today's Information Economy. Just as a plane can't fly without fuel, this economy simply can't perform well without accurate data. By misleading investors and concealing important facts, these executives have caused pervasive harm. The result: wasted resources and a long-term drag on the economy.

The damage is especially deep because of the rapid pace of change over the last few years. Investors need something rigorous to go by if they're going to shift their money quickly to the best-performing companies and sectors. Man-



agers have to have accurate data about their competitors, so they can identify and emulate the most successful ones. And companies depend on truthful reports about their own performance, so that they know when major restructuring and personnel changes are essential.

Start with the financial markets, which lie at the heart of the U.S. economy. The trend over the last 20 years has been to rely increasingly on the equity and debt markets, rather than on banks or the government, to allocate capital. When the financial markets are working well, the U.S. has a big competitive edge over Europe and Asia. U.S. capital markets can funnel money rapidly to new technologies, and then adjust quickly if new ventures don't pan out.

Misrepresentations by top executives can jeopardize the efficiency of the financial markets. In particular, the accounting misrepresentations at companies such as WorldCom and Qwest Communications kept far too much capital flowing for too long into the telecom sector—perhaps as much as \$30 billion, much of that in bonds which will never be paid back. That's money that could have been used much more profitably and productively elsewhere.

The financial markets are not the only ones to suffer when a company provides bad information. Competitors in the same industry are hurt, too. They're keenly aware of how their rivals are doing, especially in a sector with rapid technological change. If one company seems to be faring exceptionally well, everyone else tries to figure out why and copy it. That's how innovations diffuse through an economy.

That process doesn't work right if one company is lying about its performance. When Enron Corp. reported revenue growth of 70% annually from 1997 to 2000, and operating profit growth of 35% a year, that drew other electric and gas utility companies into energy trading. The fact that Enron achieved much of its gains by moving debt off the books and using other accounting tricks was not obvious at the time. Similarly, in 1999 and 2000 WorldCom Inc. reported operating profits equal to 21.4% of sales, compared to 15.4% at Sprint and 11.8% at AT&T, its two main competitors. If WorldCom's profits were in part bogus, that meant Sprint and AT&T were getting the wrong signals: They weren't doing as badly compared to WorldCom as it appeared.

Finally, companies that provide bad information to outsiders end up hurting themselves. Internal financial reports are supposed to help executives determine which parts of their company need improvement. But the accounting at companies like Enron and WorldCom hid rather than illuminated, and these troubled companies didn't make the changes they needed to survive. The result: two major bankruptcies, leading to economy-wide disruptions.

Nobody would seriously consider instituting a new class of felony consisting of "crimes against the economy." But the damage that these executives have done is measured in billions—and we are all going to pay. ■

~~~~~  
When  
one outfit  
does well,  
others  
copy it.  
That's how  
innovation  
spreads.  
But the  
process  
can't work  
if the  
company  
in question  
is lying



# After Greenspan

**Memo To: The President**  
**From: Clay Johnson**  
*White House Personnel*  
**Re: Next Federal Reserve Chairman**



**Mr. President:**

You asked me to take some soundings on what sort of person we'd like to see as the next Fed chairman. After talking to people inside and outside the Administration, I've come to a number of broad conclusions.

Of course, Alan Greenspan shows not the faintest inclination of wanting to retire. He may be 76, but he's as nimble as an intern. Must be all that market volatility that keeps him young. Greenspan isn't saying much about what he wants to do, but both your economic guru Larry Lindsey and top economist Glenn Hubbard reckon he would like to stay on past the end of his term in June, 2004. If so, everyone—from the Veep on down—thinks we should oblige him. The New Economy that Greenspan likes to preach about may or may not turn out to be real. But installing a new Fed chief, with all the second-guessing that entails, may be taking on grief we don't need when we're putting the slam on Saddam. One regime change in your first term is enough.



**By Rich Miller**

Still, it's never too early to plan. First off, we're going to need a card-carrying Republican, or the old political mastermind, Karl Rove, will blow a fuse. I know, I can just hear you saying: "Duh." But there are actually some folks out there who think this appointment is above politics. And focusing on prospects with GOP credentials means ruling out

such people as New York Fed President William McDonough and Fed Vice-Chair Roger Ferguson, a favorite of Greenspan's and an African American. But hey, that's politics. We can add a token Dem to the list we leak to the press.

We have to be careful not to overdo it—and wind up with a candidate who's too partisan or doctrinaire, though. That's because your nominee may have to pass muster with a Democratic-controlled Senate. It might even help if he were a bit of a political neophyte. That way, he'd have to look to Karl & Co. for advice.

I know you asked about a top businessman for the job. But the record of corporate leaders in the chairman's seat is mixed. Remember Jimmy Carter's pick, G. William Miller? What a dud. But the Fed even named a building after FDR's man, Marriner Eccles. By the way, Greenspan is talking about doing the same for himself with that office on New York Avenue that the Fed bought last year. If that doesn't work, my fallback plan is

to repaint and rename the 14th Street

The Green Span? Get it? (Just kidding.)

But getting back to business candidates, even if we settle on a squeaky-clean CEO, company's profits could be restated down

any time. Then we'd have a mess on our hands. Same goes for some Wall Street suit. Why, even the

sainted Bob Rubin is getting knocked for lobbying for Iron Corp. and for Citigroup's lending practices. (Yeah, know—it warms the cockles of my heart, too.)

So reluctantly, I've come to the decision that an egghead may be your best bet. Yes, I know you don't know—Larry is practically the only one you can count on without sprinting for the StairMaster. And as usual, your instincts are right. The last thing you want is an ivory-tower academic wedded to some arcane theory about how the economy works.

Mostly, you need someone who is seen as a respected and weighty figure. Someone who has a flexibility of mind and a willingness to go where the data and real-world anecdotal reports point him. Someone who doesn't appear divorced from the everyday concerns of average Americans.

What's even more important is an economist who can act coolly in a financial crisis. When I spoke to Greenspan, he suggested that unsettling financial gyrations are likely to become more frequent. Something about the growing volatility of the markets and the growing stability of the economy and how this, in the end, is all to the good for the U.S. Yeah, right, that's easy for him to say: All his money is in Treasury bills.

Which brings up another qualification. The Fed chief must be able to expound on virtually any subject—without actually saying much of anything that might telegraph future moves. Both Greenspan and his predecessor Paul Volcker are masters of the opaque. At the other end of the spectrum is Paul O'Neill at Treasury. Always says exactly what's on his mind—and bingo, the Brazilian real is down the toilet.

If you read the academic literature (don't worry, you won't have to), in theory central banks should be as transparent as possible. But there's a bit of the Wizard of Oz to being Fed chairman. After all, the Fed really controls just one lousy interest rate. Yet Greenspan has managed to convince the public and global markets that he is the second-most-powerful policymaker on the planet.

As you can see, this is not going to be easy. All the names I've come up with so far have glaring problems. Larry is too political, and Glenn is too micro. Marty Feldstein of Harvard is brilliant but combustible (yakked his way out of a job as Reagan's chief economist). John Taylor—he's the Under Secretary at Treasury, remember?—started out as our sentimental fave, but his stolid style hasn't wowed the markets. Your dad's top in-house economist, Stanford's Mike Boskin, seems like dated goods. And while Phil Gramm would love a new post-Senate career, he could trigger a double-dip recession all by his lonesome.

Oh, well, I guess it's back to the drawing board.



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# When Business Is Scared Stagnant

ECONOMY

5

Fear is on the march. And this could make Americans retreat so much from taking chances that economic growth stalls

**A**fter living through the past year, Americans have some legitimate reasons to be scared. We have learned that there are terrorists who want to destroy this country. People can be killed by opening envelopes containing anthrax. In the business world, some respected executives have turned out to be brazen cheaters. And the stock market has become far less reliable than most people were counting on. The bear market is both a symptom of the fears and a cause of them.

But there is a chance that the pendulum is swinging too far, right past prudence into the realm of unreasoning fear. There is a danger that America could scare itself into stagnation—retreating so much that economic growth stalls.

Increased caution is already hurting the economy by crimping the potential for growth and innovation. Investors have been shunning initial public offerings, depriving young companies of the money they need to grow. Venture capitalists are shutting down other promising startups before the businesses have a chance to get going. And companies in general are extremely tentative about resuming their

investment in structures, equipment, and software—prerequisites for new business growth.

At the extreme, excessive risk aversion by investors and corporations could lead to a repeat performance of the stagnant 1970s. Joel Lerner, a professor at Harvard Business School,



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the venture-capital business cooled so much during that decade that in one year, 1975, not a single venture fund was raised. Some academics speculate that the venture-capital drought of the '70s delayed the introduction of personal computers and off-data networking. Says Lerner: "With venture funds sitting on billions of uninvested capital, it's hard to feel we're quite [back to the '70s] yet. That's the ultimate thing to worry about."

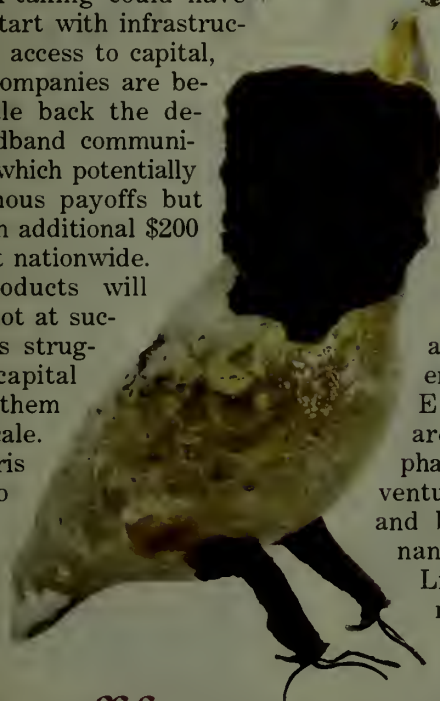
This time around, a retreat of investors from risk-taking could have a major impact. Start with infrastructure. Cut off from access to capital, phone and cable companies are being forced to scale back the deployment of broadband communications networks, which potentially could have enormous payoffs but require perhaps an additional \$200 billion to build out nationwide. Many new products will never get their shot at success, as companies struggle to find the capital necessary to roll them out on a large scale. For example, Pluris Inc., a Cupertino (Calif.) network-equipment company, was forced to fold in May in the middle of de-

Maxwell, an executive recruiter in Boston for Russell Reynolds Associates. Now, seasoned managers would rather sit tight. "There is more risk aversion than at any time during the past several years," says James W. Breyer, managing partner of venture capitalist Accel Partners in Palo Alto, Calif.

One of the less recognized advances of the boom years was financial innovation—and now that's under assault. Investment banks had engineered new ways for companies to hedge or specu-

late. Today, understandably, many CEOs don't want the words "creative" and "finance" to appear within five miles of each other. But clamping down on the legitimate use of financial tools could make companies less efficient and more unstable.

For instance, off-balance-sheet special-purpose entities, while abused by Enron Corp. and others, are legitimately used by pharmaceutical companies for ventures with biotech outfits, and by manufacturers to finance customer purchases. Likewise, it would be a big mistake to crack down too hard on over-the-counter



Cut off from access to capital, phone and cable companies are forced to delay broadband

veloping a \$1 million Internet router for high-speed networks—all because its potential customers were in financial trouble, even though the test results for the new product were good. An aversion to risk-taking could also force companies to skimp on research and development—delaying the production of as-yet-unimagined products in a variety of fields ranging from software to biotechnology to fuel cells.

It's not just about money, either. Innovative companies are having a hard time getting and retaining workers. "Three years ago, we had people standing in line wanting to go to early-stage companies because they thought there would be a windfall," says Steve

derivatives. These instruments shield companies against destabilizing interest-rate or currency shocks. As Federal Reserve Chairman Alan Greenspan testified to Congress earlier this year, derivatives "are a major contributor to the flexibility and resiliency of our financial system."

It would be especially troubling if risk becomes a dirty word. The trick is to have a clear-eyed view of the trade-offs between risks and rewards. "Risk is a choice, rather than a fate," writes investment adviser Peter L. Bernstein in his book *Against the Gods: The Remarkable Story of Risk*. A sensible level of confidence—neither the euphoria of the '90s nor the fear of the '00s—would benefit just about everyone. ■

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# The Rich Get Richer. And That's O. K.



## FLAUNTING IT:

The 19th century brought a huge rise in inequality

on economic growth as well. In most of the postwar era, periods with a widening gap between top and bottom of the income scale such as the 1970s and 1980s—decades from 1950 to 1993—have been marked by weak economic growth and rising poverty rates. By contrast, periods of narrow inequality—say, the 1960s and the early 1970s—have been accompanied by strong growth and a falling poverty rate.

But let's contemplate a heretical notion: Maybe inequality is getting a handle on it, at least from

the economic point of view. Since 1993, a widening gap between high- and low-income workers has coexisted with strong growth and plummeting poverty. During the New Economy boom, every measure of income inequality clearly got worse. In particular, wage gains for managers and professionals far outstripped those of blue-collar and service workers, and the top fifth of households collected a bigger share of income.

But unlike other periods during the past 50 years when the gap has widened, the economy prospered, and the poor did well, too. From 1993 to 2000, the latest numbers available, the percentage of people in poor families plunged from 13.6% to 9.6%, the lowest level on record. The poverty rate for 2001, when it is released in the fall, is likely to be nearly as low, because re-

## ECONOMY

# 6

In the 1990s, the gap between rich and poor widened. But poverty rates fell to record lows

# A

By Michael J. Mandel

merican culture is fundamentally egalitarian. Wide gaps between rich and poor make most people uncomfortable. So when CEOs take home huge pay packages compared with the wages for ordinary workers, the norms of fairness and social justice seem to be violated.

Income inequality has long been worrisome



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wage gains for low-income workers stayed strong that year. Blue-collar wages, adjusted for inflation, rose by 2.4% in 2001, their largest increase in years, with an even bigger jump for service occupations.

This combination of rising inequality and falling poverty could well be an enduring feature of the New Economy. In the past, periods of rapid technological innovation have created great fortunes while substantially improving the wages

trated, and the wage premium for skilled workers, such as engineers and machinists, widened sharply compared with less skilled workers. Despite the increasing inequality, living standards rose at the bottom as well. From 1865 to 1890, real wages for employed urban unskilled workers increased at a 1.8% annual rate.

A critical factor that heightens inequality but decreases poverty is the growing role of education. In the past 10 years, the percentage

of Americans aged 25-29 with a college degree has risen from 23% to 29%, and more people realize that higher education has a big payoff. The poverty rate for people with a college

education is 3.2%, compared with 9.2% for those with a high school diploma.

But, surprisingly, as Americans move up the education ladder, inequality actually increases. How so? Among a group of college-educated people, there will be a much wider spread of incomes than among a group of workers with high school education. That's because there's a fairly clear limit on the maximum amount of earnings for those with a high school diploma. Only 1% of high-school-educated workers earn over \$100,000 annually. By comparison, 13% of college-educated workers earn six figures or more—but an equal number earns less than \$25,000 annually. The result is that the trend toward an increasingly educated population actually increases the amount of inequality in the economy.

Then there's immigration, which also spurs inequality. In recent years, the new entrants

have varied greatly in terms of education and income. On the one hand, immigrants are more likely to have a college degree than are average Americans. Meanwhile, about 30% of workers without a high school diploma are immigrants, far out of proportion to their share of the population. Without immigrants, inequality would be less—but so would growth.

Still, the gap between rich and poor can have pernicious effects. Often, societies with a rich elite suffer from an undesirable concentration of political power. And the U.S. can certainly take steps to mitigate the impact of inequality by providing better medical care and education for the poor. But as long as growth is strong and poverty is low, a little inequality is a small price to pay.

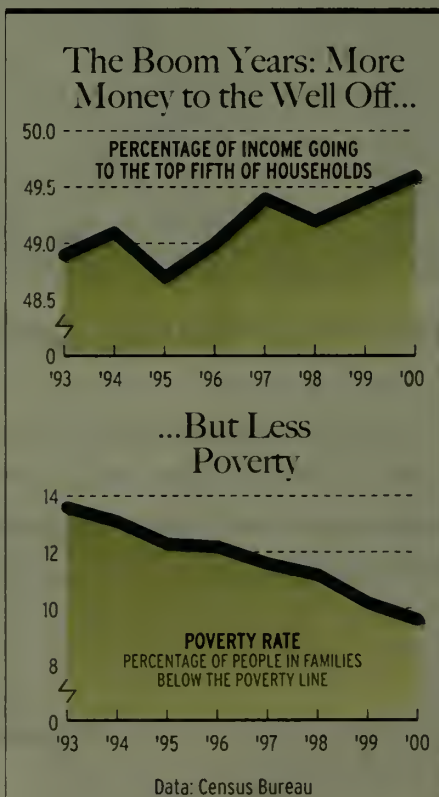
## It's better to have a wide income gap but few people in poverty than greater equality and a high poverty rate

and quality of life for the people at the bottom. In addition, the continuing shift to a better-educated society is leading to less poverty but more inequality, since people with college degrees have a wide spread of incomes. And the massive influx of immigrants into the U.S., so essential to fueling growth, has contributed to a bigger income gap. The reason: The new entrants tend to have greater differences in levels of education and income than native-born Americans.

Should this distress us? Income inequality is troubling, but poverty is criminal. Ultimately, an economy should be judged on how well it treats its poorest members. A country with more income inequality, faster growth, and less poverty is far more desirable than one with a more equal distribution of income, but higher poverty.

Past periods of technological change have had faster growth yet higher wage discrepancies. In early and middle 19th century Britain, as the Industrial Revolution got into full swing, there was a sharp increase in inequality, as skilled and educated workers did very well. At the same time, however, working-class incomes also rose at a rapid rate. According to research by Harvard University economist Jeffrey Williamson, real wages for blue-collar adult males nearly doubled between 1819 and 1851, rising at about a 1.8% annual rate. Moreover, there's evidence that the percentage of the population who were extremely poor—"paupers," as they were called—dropped during this period.

Similarly, the post-Civil War U.S. had an economic boom resulting from such factors as the dramatic expansion of the railroads. Wealth was highly concen-





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# The Copycat Economy



Once, a hot new idea spelled years of fat profits. But these days, rivals are moving into markets before you can say "clone"

# S

By Pete Engardio and Faith Keenan

cen es from the corporate battlefield:

■ For a decade, the refrigerator-size Symmetrix unit was the Goliath of the data-storage industry. Costing up to \$3 million, it enabled its maker, EMC Corp., to reap fat profit margins. Then, in 2001, IBM and Hitachi Data Systems launched similar boxes. Prices plunged 60% last year, and are down about 35% this year.

■ Kyocera Corp.'s QCP 6035 Smartphone, a com-

bination personal digital assistant and Web-ready phone priced at \$500, looked like a winner when it appeared in early 2001—until Samsung Electronics Co. launched a smaller PDA-phone with color screen months later. The Smartphone now retails for \$150.

■ Last fall, Procter & Gamble Co. thought \$50 Swiffer WetJet mop, which sprays water floors, would be the killer app of housecleaning. But then Clorox Co.'s ReadyMop forced P&G to cut its price by half in seven months.

Competition is the essence of a market economy. But rarely has it been this brutal. In numerous industries, companies are finding it increasingly hard to maintain a unique advantage long enough to make good profits on an innovation. Time was, companies could milk a new product for years before cut-rate clones arrived. Now, new TVs, packaged foods, telecom route-e-commerce concepts, and wireless services are barely out the door before rivals are on the tails, bludgeoning prices.

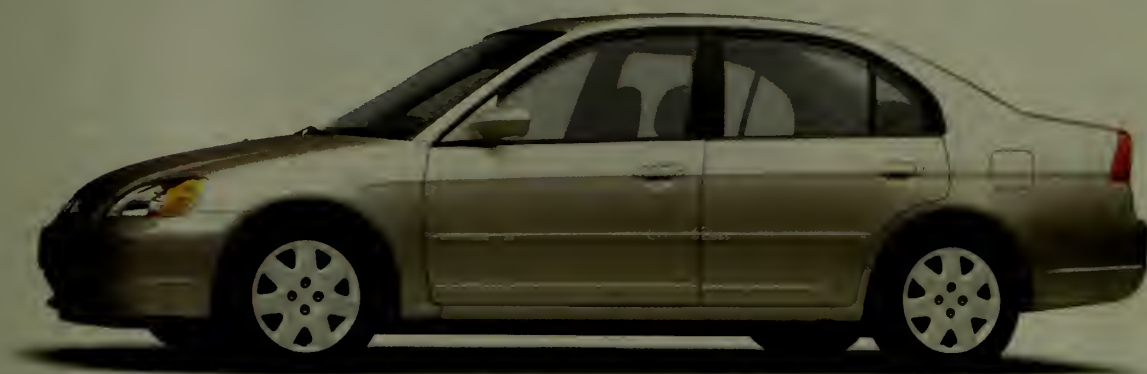
Call it the copycat economy. And it raises some critical questions: How do you make money in such an environment, especially when demand is flat? Already, the lack of pricing power partly explains why productivity gains of 3% to 4% aren't always translating into higher corporate profits. Longer term, it suggests companies may find it harder to sustain strong growth.

Many factors are at work. In pharmaceuticals, where drugmakers are hyping derivatives of blockbuster drugs like Claritin as their patents expire and generics swarm in, there's a paucity of technology breakthroughs. In electronics, digitization makes hardware easier to copy, since change is propelled by constant semiconductor and software advances. There has been an explosion

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low-cost Asian rivals. And the rise of contract manufacturing and design has lowered the entry barrier for new players who lack factories and big labs. As a result, says CEO Michael E. Marks of contract manufacturer Flextronics Corp., keeping a product from becoming a commodity "will just get harder and harder."

Even many innovative productivity-boosting strategies of the '90s are commonplace. Nearly everyone now boasts of near-zero-defect quality, efficient supply chains, and virtual design. Often, they use the same contractors, consultants, and software. The shift of business to the Net also quickens the spread of management processes. "Everyone has the same capabilities," says Allen J. Delattre, head of Accenture Ltd.'s supply-chain consulting practice for electronics. "Even speed and quality are commodities."

For consumers and the U.S. economy, this dog-eat-dog battle is terrific. The rapid dissemination of innovation has helped spur America's productivity gains. It also means lower prices and greater choice. When color TV appeared in 1956, it took two decades before the price dropped in half. It took a decade for VCR prices to halve. In contrast, prices for DVD players,



## Remember DEC and Wang? They lingered at the top of the tech world compared with today's flameouts

launched in 1997 for \$700, halved in about two years, and now they sell for \$153 on average, says market researcher NPDTECHworld. Deflation has accelerated in other sectors. Since 1997, retail prices for women's apparel are down 8% on average, reports the Bureau of Labor Statistics. Television prices are down 30% in the U.S.; monthly cell-phone service, 32%.

For companies, though, benefits can be fleeting. A Mercer Management Consulting Inc. study suggests tech leaders are flaming out at a faster rate. In the 1980s, five years lapsed from the time the stocks of Digital Equipment, Wang Labs, Control Data Systems, and other highfliers went from 50% of their peak value, hit their highs, then dropped again by 50%. By then, rivals had saturated their markets or offered better technologies. In the early '90s, Cray, Sybase, and Lotus blasted off and fell in four years. In the late '90s, Lucent, Palm, Cisco Systems, Novell, and others peaked and stumbled in less than three. Their revenues followed similar curves. Mercer's Richard Wise thinks the shrinking half-life of tech leaders points to a critical issue. "A lot of companies are hitting a growth and value-creation wall," Wise says. Less tolerance for accounting tricks exacerbates the task.

Some companies are special. Dell Computer and Wal-Mart Stores are so good at executing that they always seem to be two steps ahead of the pack. Some winners control an industry standard, like Microsoft's Windows operating system. But it's getting harder for companies to establish such standards, Wise notes. Customers and rivals have ganged up to keep Nokia, America Online, Gemstar, and others from becoming the Microsofts of their industries.

There are ways to avoid the trap. For example, more companies view their hardware platforms for pushing upgrades, spare parts, and software. That's how General Electric Co. and Sony Corp. make most of their money on aircraft engines and game players. Banks hope software and services, banks, airlines, and others use. Its data-storage gear will drive future profits. Other companies constantly pump out cutting-edge products that fetch premium prices, however fleeting. To succeed in this game, companies often must get costs down to mass production levels as soon as a new product hits the market rather than months later. "Otherwise, you'll never make money," says Dellattre. That's one reason behind Samsung's success in new cell phones.

Another gambit is to tweak existing formulas and design constantly. Thus, Colgate markets some 10 variations of toothpaste. Spanish clothing company Zara takes this to the extreme. It can modify a garment sold in its retail stores in two weeks based on customer feedback from salespeople taking notes on handheld PCs.

Some companies are doing the opposite. They focus their research on fewer products, tenaciously defend patents, and back well-established brands with heavy marketing. A \$500 million annual ad budget helps Gillette Co. charge \$30 for its new Mach3 Turbo razor and 12 replacement cartridges—while disposable razors go for \$3.29 a dozen. As part of its goal to double profit margin in five years, Unilever Group has whittled brands from 1,600 to 400. "It is increasingly difficult to develop consumer products that are truly breakthroughs," says Randy Quinn, senior vice-president for brand development. Instead, Unilever slaps its best brands on more products. Dove now appears on shower gel, deodorant, and skin cleanser.

But how long can such strategies produce growth? And as imitators try the same tactics, who is generating new demand? Or is everyone just cannibalizing each other? Eventually, companies must intensify the search for technological breakthroughs and new business models that deliver sustainable advantages. Until then, it will be hard to escape the copycat jangle.



# PROMISE TO EXPLAIN THE WONDERS OF OUR SYSTEM-ON-CHIP RESEARCH AND HOW SCOTLAND IS SHAPING THE FUTURE OF ELECTRONIC DESIGN.

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The reality is you'll find more Scots donning lab coats than kilts these days.

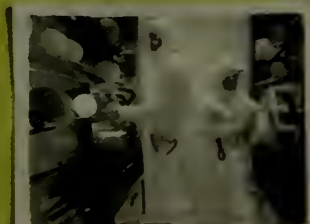
In electronic design, our innovative Alba Centre is leading the world's R&D in System Level Integration technology, as well as promoting enormously successful collaborations between top universities and private sector partners. And of course, there's Dolly, the now famous sheep who became the first mammal cloned from an adult cell—a direct result of Scotland's thriving and inventive tech industry.

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# Firepower for Financial Cops

FINANCE

8

Nothing less than an overhaul of the SEC is due. Its job would be the same—protecting investors—but its cops would be out to bust criminals, not just sue them

By Joseph Weber

**I**f the Securities & Exchange Commission didn't exist, we would have to invent it. So, let's imagine that we're starting from scratch. What should the SEC look like in the wake of the corporate scandals and the bear market that have ravaged the country for months? Would a redesigned, recast SEC oversee Corporate America and Wall Street differently? What powers would it have? Could it prevent another Enron or WorldCom?

There's certainly lots of room for improvement. Yet except for providing more money—up to \$766 million, a 66% increase, next year—and more staff, Washington is behaving as though the SEC ain't broke and doesn't need fixing. True, after years of caving to the accounting lobby, Congress and the Administration have finally mandated tougher policing of accountants and auditors. But the reforms are hardly the product of deep, long thought on how to prevent future scandals. For the most part, they're plucked from a dusty grab bag of rejected proposals made by SEC officials over the years.

The remodeled agency's core mission would remain what it has been since its creation in 1934 during the Great Depression: to protect investors and maintain the integrity of the securities markets. But because corporate chicanery has become so much more sophisticated since then, the SEC's tools for combating wrongdoing should be sharper and more effective. Today's corporate crooks make the pre-1929 purveyors of worthless stock look like pikers.

To begin with, the ability to bring criminal proceedings, with the threat of hard time,

against financial miscreants would command a lot of attention. Today, the SEC launches only civil cases against wrongdoers, either before in-house administrative law judges or in public court proceedings. Low-level workers are sometimes barred from employment in the securities industry; occasionally, substantial fines are levied on brokerage houses and banks. For example, Credit Suisse First Boston paid \$100 million in fines in January to settle allegations, which it didn't admit or deny, that it had received bloated commissions in exchange for allocating shares in hot initial public offerings to some clients. Large as they are, though, the penalties have come to be regarded as part of the cost of doing business in a tough marketplace rather than punishment. That's especially true since most SEC cases, such as CSFB's, are resolved without any admission of wrongdoing.

Even after the latest reforms, the SEC will still have to turn to the Justice Dept. on criminal matters. That cumbersome process can lead to wasteful turf battles. What's more, the tough-as-nails prosecutors at Justice can independently choose to take up corporate cases—sometimes in conflict with the SEC staff—as they did in the prosecution of auditor Arthur Andersen LLP. It would make more sense for a crew of elite SEC prosecutors who have worked up criminal cases to handle them on their own. And in enforcing new mandates for prison time for CEOs who

break trust with shareholders, SEC lawyers, schooled in the subtleties of corporate crime, surely would have a leg up on their peers at Justice.

Assembling such a team of bloodhounds at the SEC would offer other pluses. For one, they could use tools now denied to SEC investigators, such as wiretapping and broad (rather than narrowly targeted) searches. Here, it would be as if the SEC borrowed some of the power of the FBI. "If I were to make one change, it would be to give criminal-enforcement power to the SEC," says David S. Ruder, a former commission chairman who teaches law at Northwestern University. "With criminal-enforcement power, you would have much broader investigative power," Ruder adds.

With just four large accounting firms left after the withering of Andersen, the SEC should also have the power to bust up overly concentrated firms in the future. An antitrust-review mechanism, coupled with routine policing, might be just the right amount of power for the recently mandated accounting-oversight board that will work under SEC auspices.

Taking a page from the Internal Revenue Service, the oversight board also should be able to launch random audits of companies and not just their auditors, which the regulatory team can now review under the new board's mandate. "To have a group at the SEC that occasionally goes in and audits the auditors, or does some kind of audit of major public companies, would not be such a bad thing," says Roberta S. Karmel, a professor at Brooklyn Law School who served as an SEC commissioner from 1977 until 1980.

Like any crackerjack police force—and, essentially, the agency is a police force to protect investors—the ideal SEC would not wait for law-breakers to come to light. Instead, the ideal agency would act more like the one headed by former Chairman Arthur Levitt Jr. In 2000, when he was worried about Wall Street getting information ahead of ordinary investors, for instance, Levitt championed Regulation FD (for "fair disclosure"), forcing companies to stop playing favorites among analysts for news leaks. The result has been extraordinary disclosure, aided by the Internet and its ability to let companies instantly Webcast their news. As current Chairman Harvey L. Pitt now argues, the SEC should champion even more frequent releases of information, scrapping the habit of companies withholding important news until the end of a quarter.

Sure, such far-reaching changes might alarm small-government advocates. Folks whose anti-

## A Better SEC

*The securities cops are getting more money and staff. Here's what they also need:*

**POWER** to break up overly concentrated accounting firms

**RIGHT** to launch criminal cases against wrongdoers

**ABILITY** to use tools such as wiretaps in probes

**AUTHORITY** to make random audits of company financials

government views have held sway since the days of President Ronald Reagan would be troubled by an SEC that could work better and move on more fronts. "If government could ever get itself to be more efficient, we'd all be in danger," argues Edward H. Fleischman, a former SEC commissioner appointed by Reagan who now is a senior counsel at the Linklaters law firm. But even Fleischman is weary of constantly seeing fresh scandals in areas where the commission is supposed to be on the case, such as in auditing. "In retrospect, [the SEC] should have been harsher and probed further" into the likes of Andersen, he concedes.

Would a thorough overhaul of the SEC threaten fundamental liberties that businesses now enjoy? No. The laws are already in place for reining in miscreants. What's missing is better policing. With the scandal-a-day environment rapidly turning those now infamous "few bad apples" into a full orchard, a few far-reaching changes would be just the right move. ■

Washington is behaving as though  
the SEC ain't broke and doesn't need fixing  
beyond some minor tinkering





# The Downside of Disclosure

FINANCE



Too much data  
can be a bad thing.  
It's quality of  
information that  
counts, not quantity

# G

By Nanette Byrnes

ibboney Huske is a pro when it comes to sifting through corporate reports. As an analyst at Credit Suisse First Boston, she covers 11 companies in the imaging industry and is regularly recognized as one of the top interpreters of the field. She's a certified financial analyst, has a staff who works with her,

and has access to state-of-the-art technology. If anyone was up to tackling the 1,000-page Xerox Corp. annual report issued on June 28, it was Huske. Yet, two weeks later, having worked both weekends, Huske and her staff were still analyzing the massive document.

If a professional stock analyst has that much trouble getting her arms around a company's financials, what hope is there for the average investor? True, Xerox had an extraordinary amount to explain—including a restatement of five years of numbers required by the Securities & Exchange Commission. But almost every company is putting out longer, more complicated reports these days. Even those with far less complex finances are weighing in with a mind-bending 500 pages plus.

Driving this corporate loquaciousness is a growing demand for increased disclosure following this year's string of corporate frauds and accounting misbehavior. Everyone from the White House to President George W. Bush has demanded that investors be given more information. And fast. The SEC has proposed cutting the time allotted for filing quarterly reports to 30 days after the end of the period from 45. Annual reports now have to be mailed in 60 days, down from 90. But while outraged politicians and regulators demand more, one vital point goes ignored. Investors don't just want more information—they want better information. "I thought in this

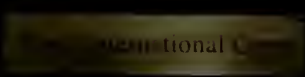
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to the company network.



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financial data, from anywhere.



I hear they've got a machine  
that makes coffee.



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mate companies would be bending over backwards to do the right thing," says Charles L. Hill, director of research at Thomson Financial/First Call, which tracks Wall Street earnings estimates. "But of the 900 pages of a filing, probably 899 of them are ginned up by the lawyers to cover their butt."

Too much disclosure may indeed prove to be a very bad thing, if the ton of chaff makes it impossible to find the kernels of truth. The best hope for investors is that the current uproar will provide fuel for a second phase of reform, one in which disclosure is fundamentally restructured to make it more useful.

Since communicating a company's relevant information to investors is the whole idea behind filing quarterly and annual reports, it's a serious problem that these documents are becoming nearly impenetrable. It's particularly troubling because there's some early evidence that companies are not interested in improving the quality of their reports. Case in point: the SEC's demand in December that companies provide a clear explanation of how pro-forma earnings numbers were calculated and how they relate to earnings as calculated under generally accepted accounting principles (GAAP). Sadly, little has improved since. Companies like Solec-tron Corp., which immediately vowed to stop issuing pro-forma figures, are back at it. And that reconciliation of GAAP with pro forma? Very hard to find.

Overwhelmed by this flood of useless data, investors are increasingly relying on intermediaries to interpret what it all means—an ironic turn, given that the ethics and veracity of Wall Street analysts are under fire. "Without spending literally hours studying the financials, the notes to the financials, the management discussion and analysis, it's increasingly impossible to analyze a company," says Steven M.H. Wallman, founder of FolioF'n Inc., a Web-based investing service, and a former SEC commissioner.

If that cry gains enough momentum, there is hope that real change can still come. Samuel A. DiPiazza Jr., chairman of PricewaterhouseCoopers, proposes a three-step reform in a book he co-authored, *Building Public Trust: The Future of Corporate Reporting*. He advocates using a less technical approach to auditing similar to the current European system, rather than the

detailed rules of the GAAP. The hope is that would make management both responsible and accountable for choosing the accounting method that best reflects the economics of the business rather than hiding behind detailed rules.

He wants disclosure of half a dozen or benchmarks that can be used to measure financial and nonfinancial performance in each specific industry, with all such companies following the same rules. And he would include a disclosure about issues of great importance to a specific company. "That's much better disclosure," says DiPiazza, "because it would help investors make better judgments."

Even without such fundamental change, there are steps that could be taken to greatly improve the usefulness of corporate information. One that has gained momentum in the past two years with Nasdaq, as well as the International Accounting Standards Board and major corporations such as Microsoft Corp., is to create a technical standard that would be used to "translate" basic categories of financial information in corporate reports. The same standard would then be embedded in software programs used by investors and regulators. Advocates say that a sensible Business Reporting Language (XBR) would make it much easier for almost anyone to wade through voluminous disclosures, via computer, for the numbers they need to analyze a company's performance.



## Data, Data Everywhere

*Here are some of the demands for more corporate information*

**CONGRESS** Recent legislation requires that companies include material off-balance-sheet transactions in quarterly and annual reports, file stock ownership by officers and major stockholders faster, and issue a management assessment of internal financial controls.

**SEC** Rule changes would require disclosure of critical accounting policies, employee stock ownership lock-out periods, and rating agency decisions. Also, CEOs and CFOs must certify all quarterly and annual reports.

**NEW YORK STOCK EXCHANGE** New rules say CEOs must attest to completeness and understandability of investor information, and publish corporate governance guidelines and a code of business ethics.

The bust-up of the go-go '90s has exacted an enormous price—in the markets, in the reputation of executives, and in the trust in Wall Street analysts and corporate auditors. One beneficial legacy of such an era of pain would be if corporations could give us a clearer picture of their performance. But for disclosure to be valuable, it has to be aimed at informing investors on the issues they truly care about and presented in a way they can understand. If regulators lose sight of that in their push for change, they may have missed their best shot at true long-term reform.

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# Abolish Paper Money

FINANCE

10

O.K., O.K.—not all paper money, but certainly bills over \$50. They'll be mourned only by tax cheats, drug dealers, and other criminals

G

By Lewis Braham

Braham's Law holds that bad money tends to drive out good. These days, though, cash itself—loot, moolah, clams, bread, the dear old greenback, in short—is getting whacked. Go to the movies, shop for groceries, and the cashier is delighted to run a debit card through a terminal that zaps payment straight to the vendor's account. On many highways, an electronic pass pays the toll. And when you write a check, the money is switched from your account to the recipient's electronically.

So, is the much-forecast day of the cashless society upon us? There's no question that consumers love the convenience of electronic money. Last year, they paid just 19% of their \$5.4 trillion worth of transactions in cash, vs. 25% of payments totaling \$2.3 trillion in 1990, according to *The Nilson Report*. By 2020, figures Nilson publisher David Robertson, little more than 10% of payments will be in cash. "The technology now exists for a paperless society," he says.

But cash isn't about to be consigned to the museum. Imagine having to pay for such items as a newspaper or a delivery tip without small bills or coins. Besides, the cost of converting billions of parking meters and vending machines to accept electronic payment would be astronomical.

Although consumers are using a lower proportion of cash in making payments, they still hold plenty. The Federal Reserve figures there's enough of the green stuff in circulation for every man, woman, and child in the U.S. to have \$2,178 in bills stuffed under the mattress. But, says the Fed, the average adult carries around only about \$100 in cash. So where's the rest? About half is circulating



abroad; the other half is used in illicit activities, such as tax evasion and drug peddling.

Criminals prefer paper currency because largely invisible to the government. All-c transactions drive a thriving underground economy of businesses, from corner stores to laundromats and restaurants, that don't declare substantially underreport their income to Internal Revenue Service. According to the IRS estimate, some \$278 billion in tax revenue was lost from such businesses in 1998—more than 15% of the \$1.8 trillion taxes paid.

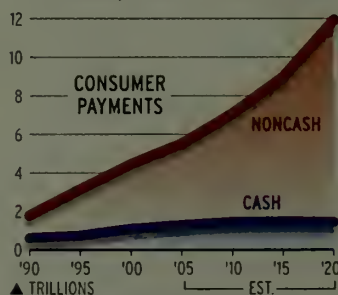
Police, tax collectors, and regulators would have a much simpler job stomping on tax evasion and crime if the use of electronic currency were mandatory. The electronic trail it leaves is easy to follow. Even checks and money orders leave electronic traces when they're cashed. Electronic money also would help protect the private sector against criminal activities. For example, First Data Corp., the largest U.S. processor of electronic transactions, has a system for wire transfers that raises a red flag if it prevents the transaction when a known dealer tries to launder money.

Happily, compulsion may not be necessary.

If present trends continue, criminals and tax bilkers will eventually be the only users of cash. The mere possession of a big stash of the stuff will attract the attention of cops, just as the ability to produce a satisfactory ID does now. Rather than ban paper money altogether, let's get rid of the large bills, say \$50 and up, that are most used by criminals. Life would go on as before. After all, in New York City, cab drivers can refuse anything bigger than a \$20 bill, and the plan still works.

## Bye-Bye, Greenback

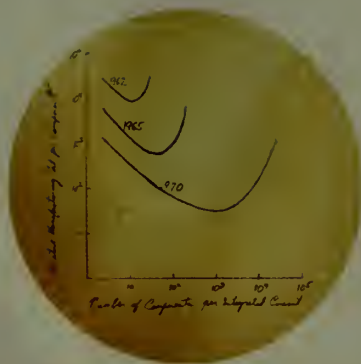
Increasingly, consumers prefer to pay with cards, checks, and e-money rather than cash



Data: The Nilson Report

## Will Moore's Law stand forever?

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# A Yardstick for Corporate Risk

Current measures of a company's health—and its ability to handle adversity—are inadequate. Here's what we need to know

# A

By Emily Thornton

Il hail to the new chief! The chief risk officer, that is. Roughly half have been appointed in the past year, making the job one of the fastest-growing in the upper ranks of Corporate America. The timing is no coincidence: Fiascos such as Enron Corp. and WorldCom Inc. are a sharp reminder to boards and CEOs that handling risk—to a company's operations, market, credit standing, and reputation—is a top priority that can't be left to low-level employees.

What's at stake is a company's very survival. In a changing investment climate, capital will flow only to those the market judges to be the savviest risk managers. The rest face a dim future in which they pay much more for credit and their stocks trade at big discounts.

The biggest shock awaiting laggards is just how much information they'll have to disgorge to get favorable treatment. At present, most companies divulge little—or nothing—about how they monitor risk. Some won't even reveal whether they have a chief risk officer, let alone key information such as how they conduct internal audits or what assumptions they make in fixing their reserves for bad debt. "This is the next wave of information that needs to be disclosed," says Robert Willens, a tax-and-accounting analyst at Lehman Brothers Inc.

Some of this information will be a more thorough disclosure of a company's numbers, such as how much credit in all forms it can tap. But much will be less tangible, such as whether company borrowings have triggers that could force early repayment or how much a company is exposed to major legal claims. And yet, other information will be hard to quantify, such as how good management is. Difficult, but not impossible: In the fall, ratings agency Standard & Poor's, like *BusinessWeek* a unit of The McGraw-Hill Cos., will score U.S. companies on their corporate-govern-



FINANCE

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nance and disclosure practices. "There needs to be a different kind of tool to measure corporate risk management," says Eugene A. Ludwig, managing partner for financial risk-management consultant Promontory Financial Group LLC.

Here are some key factors that should be weighed in deciding how risky any business is. ■ **LIQUIDITY TRAP** Even if a company has low service debt, the way it manages its financing creates a set of separate risks. Moody's Investor Service said in a survey published in July that

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771 investment-grade U.S. companies had disclosed only 22.5% of their triggers—some of which could force them to accept much worse terms on outstanding loans if their credit rating falls. Companies should disclose such potential time bombs and report how much credit in all forms they have available. Such information might have saved shareholders of Tyco International Ltd. some of the \$90 billion they've lost since January. If Tyco had disclosed its borrowing capacity and its covenants, investors could have seen that the company needed to sell assets to service debt. And they could have bailed out. "How can you make a good assessment of risk

without that kind of information?" says Henry Kaufman, who runs his own consulting firm, Henry Kaufman & Co.

Piles of off-balance-sheet commitments and potential liabilities, including lawsuits and environmental obligations, can come back to haunt a company. In this year's second quarter, oil-services giant Halliburton Co. took a \$483 million pre-tax charge for asbestos liabilities, many of which landed in its lap when it bought Dresser Industries in 1998. Though the claims were in Dresser's accounts, the company believed it was indemnified. "No one could have predicted what would have happened," says spokeswoman Wendy Hall.

#### ■ GUESSTIMATE GAME

Much of what is presented as hard information in financial statements is in fact a guess based on multiple—and often unstated—assumptions. Many banks and credit-card companies, for example, set loan-loss reserves without revealing the assumptions they use to calculate them. They need to disclose such information and warn shareholders how their financial picture would change if their assumptions are off by, say, 1%, 5%, or 10%.

Wildly optimistic assumptions come with a high price. Companies in the Standard & Poor's 500-stock index may end up as much as \$150 billion short of their projected pension obligations, mainly because they bet wrong on how stock prices and interest rates would move.

■ **COMPLIANCE COMPLEX** Auditors provide so-called Management Letters, which assess the quality of their client's internal auditing. Shareholders need that information, but they don't get it because companies aren't required to reveal it.

Companies need to disclose at least how big their internal audit staff is and what they do.

How often do they meet? How much time of the CEO spend with the team? And most important, has the company ever demoted a compliance officer after there has been a failure of controls? By simply disclosing how many officers must certify capital expenditures above a certain amount, for example, companies could reassure shareholders that their CFO isn't like WorldCom's Scott Sullivan, who allegedly disguised \$3.8 billion in expenses as capital expenditures to pump up the company's operating profits.

■ **PEER PRESSURE** Of course, some information that would go into a risk scorecard is available already. It just hasn't been fully utilized. A com-

pany that is growing fast compared with peers is a red flag for risk mavens—especially if its most successful new business is new and managed by executives with little experience in it. Just look at Enron, which ran to make itself a dominant trader of not only electricity but also commodities such as broadband bandwidth, water, and airtime, about which its executives presumably knew little.

■ **BOSS FACTOR** Executives have to know how to handle a sharp economic downturn. So hip youngsters and financial-whiz bosses are out these days. Experienced executives with backgrounds in compliance and legal affairs are in.

Bosses' interests need to be aligned with those of shareholders so they can't make out like bandits while driving their companies into the ground. "There ought to be more discipline in the use of stock options," says Carol Bowie, director of governance research at Investor Responsibility Research Center. One possibility: compensation packages that require execs to keep most, if not all, their option shares for at least a year after they leave. That would have probably given trouble Qwest International's former CEO Joseph P. Nardone pause. He collected \$248 million on stock sales before resigning from the company. Henry Schacht, chairman of Lucent Technologies Inc., would even revise the tax system to underscore the message. "I would say you can trade [your options] anytime you want, but if you trade in the first 60 days of receiving them, you pay a 90% tax. The longer you hold it, the less you pay," he says.

That may sound drastic, but it would certainly focus top execs on risk and the need to manage it. The biggest risk is not taking risk seriously.

## Risky Business

*The more bad points a company has, the higher its score—and the more caution an investor should use*

POTENTIAL SCORE

**GUESSTIMATE GAME** Company does not disclose the assumptions embedded in its financial statements—and the consequences if they're wrong. 30

**COMPLIANCE COMPLEX** Company refuses to discuss the size and function of its internal audit staff, making an investor wonder if they even exist. 30

**LIQUIDITY TRAP** Loads of off-balance-sheet liabilities are buried in footnotes, and company remains mum about exactly how much credit it has available. 20

**PEER PRESSURE** Company is racking up earnings faster than rivals. But its management team has no experience in the fast-growing new business that's propelling the company. 10

**BOSS FACTOR** A management team has never managed through an economic downturn and will get paid megabucks whether the company pulls through or not. 10

Data: BusinessWeek

Grand Total: 100



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# Brainpower on the Balance Sheet

## FINANCE

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Intangibles such as brands and intellectual property comprise well over half the market value of public companies. They should get toted up like other assets. The question is, where and how?

**I**t may be a strange time to say this, just when the world is clamoring for truth in accounting. But what companies really need is greater tolerance of uncertainty. They should be allowed to assign dollar values to intangible assets such as patents, brands, and customer lists. With a better grasp of invisible assets, investors can make wiser decisions—though accounting authorities may not come around to this notion for another 20 years. This fictional balance sheet (right) shows one possible approach, toting up intellectual property alongside plant and property.

As the embodiment of ideas, intangibles are what drive growth in an information economy. Baruch Lev, an accounting professor at New York University, reckons that in the late 1990s, businesses invested approximately \$1 trillion per year in such assets. Taken together, intangibles comprise well over half the market value of public companies. Yet, with statements prepared under U.S. generally accepted accounting principles (GAAP), investors can only guess at their value or makeup. Current reporting practices “fail to provide adequate guidance to managers, investors, or public policymakers,” says Lev—though he does not expect a sea change any time soon.

In order to better milk their patents and brands, some companies do attempt to measure their worth. But such numbers are rarely for external consumption. Even when used internally, they can cause problems. If you miscalculate the future income from a patent, you may commit to building a new plant that you can't afford. Fortunately, measuring tools are improving. And as a result, many countries are becoming comfortable with intangibles. Already, a dozen or so nations, including Britain and France, permit the recognition of brands as assets on the balance sheet. Intellectual property could be next.

Yet for most U.S. companies, the risks of such disclosure still outweigh the benefits. With

## GREEN SCIENCE INC.\*

Consolidated balance sheets, in millions, at December 31, 2001

### ASSETS

#### Current Assets

Cash and equivalents  
Accounts receivable  
Inventories

#### Total current assets

#### Investments, net

#### Plant & property, net

#### Intangibles

Brands  
Intellectual property  
Process & systems  
Sustainability & environment  
Goodwill

#### Total intangibles

### TOTAL ASSETS

### LIABILITIES AND STOCKHOLDERS' EQUITY

#### Current Liabilities

Notes & accounts payable  
Debt due within one year  
Accrued and other current liabilities

#### Total current liabilities

#### Long-Term Debt

#### Other Noncurrent Liabilities

Borrowings on intangibles  
Deferred income tax liabilities, noncurrent  
Pension and other postretirement benefits,

#### Total other noncurrent liabilities

#### Stockholders' Equity

Common stock  
Retained earnings  
Intangible capital  
Net stockholders' equity

### TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY

intellectual property, for example, how do you price a batch of freshly minted patents that have yet to produce revenue? “Companies worry that inaccurate measurements or surprise writedowns [of intangible assets] will get them sued,” says Halsey Bullen, senior manager of a project study intangibles at the Financial Accounting Standards Board. FASB agrees that greater disclosure is the way forward. Just where to recognize intangibles is another question. “Maybe in the footnotes,” Bullen offers. Okay, that’s a start. Small print or large, these assets deserve to see the light.

|                                       |               |               |
|---------------------------------------|---------------|---------------|
| Intangibles                           | 1,829         | 1,805         |
| <b>A</b> Brands                       | 6,072         | 4,311         |
| <b>B</b> Intellectual property        | 4,513         | 4,373         |
| <b>C</b> Process & systems            | 2,708         | 3,087         |
| <b>D</b> Sustainability & environment | 328           | 615           |
| Goodwill                              | 15,450        | 14,191        |
| <b>Total intangibles</b>              | <b>29,057</b> | <b>28,155</b> |
| <b>TOTAL ASSETS</b>                   |               |               |

2021

220

2,044

1,342

3,606

3,489

5,869

1,805

4,311

4,373

3,087

615

14,191

8,155

3,875

101

719

4,695

2,106

1,916

1,330

1,015

4,261

781

4,036

12,276

7,093

8,155

Balance sheet

BusinessWeek

v

**A**

## Brands

In mergers and acquisitions, companies ask consultants to help determine the value of any acquired brands. But few companies ever record the value of these intangible assets in their annual reports. That's surprising when you consider that for consumer-goods makers, brands can make up the bulk of their total capitalization. This became obvious in the merger wave of the 1980s, when such brands as Nabisco and Kraft were in play. But until recently, brands were lumped into aggregate goodwill—even though goodwill always depreciated, while brands may not have. Now FASB allows companies to break out the value of acquired brands. Beyond the U.S., a dozen or so countries permit corporations to recognize the value of both their homegrown and acquired brands on their balance sheets.

**C**

## Process

"Organizational capital" is the term New York University professor Baruch Lev uses to describe the qualities that enable General Electric to quickly boost efficiency and profits at the companies it acquires. Organizational processes, in other words, can be important intangibles. At GE, these processes range from sweeping Six Sigma quality initiatives down to seemingly trivial rules of etiquette. Lev calculates the value of processes as the balance that remains once all the other forms of identifiable intangible capital—such as intellectual property and brands—have been subtracted. And he hopes to put a dollar sign on this variable, suggesting that someday an overachiever such as GE could rely on the intangible value of its processes—as well as a good reputation—to boost its share price.

**B**

## Intellectual Property

Patents, trademarks, and trade secrets are at center stage in most discussions of intangible assets. Without them, the ideas at the heart of computer software, music, and games, not to mention all forms of industrial innovation, would be unprotected from piracy. Yet intellectual property remains largely unrecorded as an asset anywhere in the world. On its income statement, IBM itemizes more than \$1 billion in earnings each year from its intellectual property portfolio but doesn't recognize the underlying patents as assets on its balance sheet. There are many reasons this state of affairs should change, says Kevin Rivette, author of *Rembrandts in the Attic*. Once patents and trademarks are recorded as assets by owners of large intellectual property portfolios, managers would be able to borrow against the value of these assets.

**D**

## Environment

What does ecology have to do with financial performance? Plenty. More than 300 companies, including Dow, DuPont, IBM, Intel, Nike, Shell, and Timberland, publish environmental supplements to their financial reports. And as intangible assets, green commitments are more than just good PR. The U.S. and other countries, for example, permit trading in sulfur dioxide emission credits. These can be a means to cap waste and make polluters pay for indirect costs of pollution, such as health care and cleanups. Green companies face lower overall risks as well, says Thomas Streiff, group head of sustainability at Swiss Re, a Zurich-based insurer. That means lower insurance premiums, and over the long run, lower costs of capital. "There's a link between soft green practices and overall business performance," he adds.



# Small Is Profitable

# U

By Manjeet Kripalani and Pete Engardio

Ushaben Patel, a 37-year-old housewife from Navali village in India's Gujarat state, awakens at 5 a.m. each day to milk her cow. A half-hour later, she is at the village milk cooperative center. There, her seven liters of milk are measured and tested. She repeats the routine in the afternoon. Her daily take: \$2.80. The money goes a long way. It helps pay for necessities and her two sons' schooling. In fact, the cooperative's impact is visible throughout Navali. In all, 932 of the 6,000 villagers are members, and they have earned enough to help build a new road and housing for schoolteachers. Last year, they even sent money to help earthquake victims elsewhere in Gujarat.

A heartwarming antipoverty project? Hardly. The cooperative in Navali is one of 175 involving 2 million people in villages across India affiliated with the country's biggest dairy-products company, Anand Milk Union Ltd., better known as Amul. The village collection points are just the beginning of a supply chain that otherwise resembles that of any sophisticated corporation. Amul's processing plants and packaging are first-rate. Because it has its own low-cost sources of raw milk, Amul's cheese, ice cream, and chocolates are seizing market share from the likes of Nestlé and Unilever Group. With sales of \$612 million—growing 25% annually—Amul also has lofty ambitions. It views itself as a budding multinational, and already exports to the U.S., the Middle East, and Africa.

The late E.F. Schumacher would approve. In 1973, the English economist-philosopher wrote *Small Is Beautiful: Economics as if Peo-*

GLOBAL

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What will work in the developing world is a focus on inexpensive, downsized, simple-to-use products





**THE ROAD IS  
PAVED WITH MILK:**

The Navali cooperative is one of 175 across India affiliated with a dairy conglomerate with annual sales of \$612 million

*ple Mattered.* Rather than being forced into the industrialized world's rat race, Schumacher thought people in developing nations should be able to get ahead by means of traditional lifestyles. Rather than megaprojects, industries should be "human scale." Rather than believe science will solve all life's problems, there should be "appropriate technologies" that average people can use without poisoning the planet. This ideal was a hit on college campuses, but widely viewed as an impractical model for economic development.

But if Schumacher were alive to write a sequel, it might be called *Small Is Profitable*. And not just utopians would be treating him as a guru. Companies such as Unilever, Philips, Coca-Cola, and Motorola are finding that a focus on low prices, miniature sizes, and simple-to-use products may be the secrets to business success in developing nations, where most of the world's population dwells. In finance, banks specializing in micro-loans of as little as \$100 are the rage as a means of spurring sustainable, grass-roots development. The approach is drawing praise from U.S. Treasury Secretary Paul O'Neill and the World Bank, and is starting to win the attention of heavyweights such as Citibank and Standard Chartered Bank. Engineers in research labs from Bangalore to Boston are scrambling to develop cheap wireless phones and computers simple enough to be used by illiterates.

All these efforts are aimed at what could well be the biggest source of economic growth in the coming decades: the two-thirds of the global population now making \$1,500 or less annually. Companies like Amul hope to prove it is economically viable to employ the rural poor in a multinational enterprise without destroying their traditional lifestyles. Others see the "bottom of the pyramid" of the global population as future consumers. "Low-income people are a very important market for us," says Antonio Leon de la Barra, global marketing manager for skin-care products for Unilever. The company expects developing nations to account for half its global sales by 2010, compared with 32% now. "There are billions of people who aspire to better brands, but can't afford them yet."

For Unilever, the poor already are a huge market. The \$50 billion Anglo-Dutch consumer-goods giant has made an art of selling its products in tiny packages costing a few cents each. The conglomerate's Indian subsidiary, Hindustan Lever Ltd., adopted the concept in 1987. It began selling single-use sachets of Sunsilk shampoo for 2¢ to 4¢. Now, mini-packages account for half of Hindustan Lever's \$2.4 billion in sales in India. And the strategy has gone global. Unilever's Rexona brand deodorant sticks sell for 16¢ and up. They are big hits in India, the Philippines, Bolivia, and Peru—where Unilever has grabbed 60% of the deodorant market. A nickel-size Vaseline package and a tube containing enough Close Up toothpaste for 20 brushings sell for about 8¢ each. In Nigeria, Unilever sells 3-inch-square



packets of margarine that don't need refrigeration.

Unilever's success is inspiring companies that aim to meet the basic needs of the poor. A good example is Brooklyn (N.Y.)-based Scojo Vision. Co-founder Jordan Kassalow, an optometrist who ran a river-blindness-prevention program in Africa and other regions, noticed a huge need for simple, nonprescription glasses—but many people can't even afford \$30 to visit an eye doctor for a check-up and to buy regular glasses. "There are hundreds of millions of people who have no access to this very simple product," says Kassalow.

So in March Scojo began selling nonprescription glasses in El Salvador, India, Haiti, and Guatemala for as little as \$2 a pair. The glasses come in just three strengths. For distribution, Scojo is training dozens of small entrepreneurs and providing them with loans of about \$75 so they can buy a kit of eye charts, brochures, and a stock of glasses. Scojo has sold several thousand pairs so far and figures it needs to sell 100,000 a year to become profitable.

Technology companies also are learning to reach low-income people. London's Freeplay Energy Group, for example, has helped pioneer the windup radio. In



1996, Freeplay designed its first radio charged by cranking a handle so that Africans could listen to public-service broadcasts of health and agriculture information and school lessons. Only 30% of sub-Saharan Africa homes have electricity, and since per capita incomes are \$100 to \$300 a year, many cannot afford to regularly buy batteries.

Since then, Freeplay has sold 3 million radios. In the West, where they sell for up to \$100, they are popular among campers. But they're sold at a discount to aid agencies and governments in poor nations. In Rwanda, Freeplay's radios went to 65,000 teenagers who are heads of their households because their parents died in civil strife. By expanding unit sales, Freeplay hopes to drive production costs down dramatically. It also has launched windup chargers for Coleman Co. flashlights and Motorola Inc. cell phones, and hopes to do the same for medical testing equipment. A private company, Freeplay says its radio business is profitable.

Big consumer-electronics companies are joining

## The Mantra: Keep It Affordable



### WIND-UP RADIO

**Manufacturer** Philips Electronics

**Where sold** India

**Market** People who lack reliable access to electricity or can't afford batteries

**Price** \$20

### MINIATURE PACKAGES OF TOILETRIES

**Manufacturer** Unilever

**Market** Consumers who want quality brands but can afford them only occasionally

**Where sold** Philippines, India, Indonesia, South America

**Prices** 2¢-31¢



### READING GLASSES

**Manufacturer** Scojo

**Where sold** Guatemala, India, El Salvador

**Market** People who can't afford eye doctors

**Price** \$2 and up

the fray, too. Royal Philips Electronics retold windup radio for mountaineers and in March began selling simple versions for \$20 in India. Philips has sold nearly 3,000 windups and hopes to sell 100,000 by yearend. "This will help Philips be a market leader here," says Rajeev Kar, Philips' India CEO.

Affordability and simplicity are the mantras driving technicians who are searching for creative ways to deliver wireless telephony and other services to remote villages. "People are bubbling up with ideas all over the place about this," says MIT Media Laboratory scientist Michael L. Best, who heads several tech corporations in Asia.

With its army of engineers and enormous population of rural poor, India is a hotbed of such innovation. In Madras, a startup called N-Logix has commercially deployed a system for transmitting wireless services to Internet kiosks and phone centers in 15,000 villages across India. Each line costs \$300, compared to \$1,000 for a conventional fixed phone line. Although conditions aren't as fast as with state-of-the-art technologies, they offer Internet service for just an hour and are good enough to provide video conferencing for hospitals and colleges. And in August, Encore Software Ltd. will roll out Simputer—a handheld device starting at \$100 with easy-to-use software interfaces that translate several Indian languages from speech to text and vice-versa. A team from the Indian Institute of Science in Bangalore has designed Simputer software that even an illiterate person can use, says Chairman Vinay Deshpande. The device will also access a Global Positioning System, enabling farm cooperatives to obtain current produce prices and traveling paramedics to send patient data to hospitals.

Some futurists predict that the small-is-profitable movement will bring about a new breed of multinationals. Already, Unilever and Amul have "fundamentally rethought the nature of the large enterprise—as well as the small enterprise," says University of Michigan management guru C.K. Prahalad. Successful multinationals of the future, Prahalad predicts, will have sophisticated global management of marketing and supply chains. But they'll also have roots firmly planted at the village level. "The challenge will be to create large, virtual organizations in developing economies that have the benefits of scale, but the uniqueness of small size," he says.

Amrita Patel, chairman of India's National Dairy Development Board, agrees. She notes that Amul is owned by a network of village cooperatives. In fact, last year, Amul dispersed half of its \$12 million in earnings to farmers who are shareholders. Such a model could help other rural cooperatives producing everything from fruits to flowers to sell their products around the world.

Village cooperatives. Alternative technologies. They may sound like a blast from an idealized past. But small is beautiful could well be the wave of the future.



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# Lessons from The Fastest-Growing Nation: Botswana?

GLOBAL

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GDP in the diamond-rich economy has skyrocketed thanks to free-market principles and prudent management. And its AIDS offensive is showing Africa the way



**ONE LUMP OR TWO?** Botswana offers an economic model for the developing world

**Q**

By John Koppisch

quick—name the country that's grown the fastest over the last few decades. It's not any of the four Asian Tigers, though they come close. It's not China—its economy didn't get going until the 1980s. Surely it wouldn't be any country in Africa, where every decade is a lost decade.

Wrong. The country posting the highest gross-domestic-product growth since 1966 is Botswana,

a landlocked nation in southern Africa that's two-thirds desert. Its economy has expanded an average of 7% a year since it won independence from Britain that year, according to the World Bank. And it continues to expand—growth is projected at 5% this year—despite a rampant AIDS epidemic that is now the country's biggest challenge. On a continent where virtually every country is worse off than it was at independence, Botswana offers some lessons in economic management for its neighbors.

What accounts for Botswana's sterling achievement? The easy answer would be diamonds, discovered under the desert in 1967. And diamond mining is indeed the keystone of the economy. But odd as it may seem, natural resources like diamonds, gold, or oil are often more of a curse than a blessing. Examples are chronically unstable Venezuela (oil) and the war-torn former



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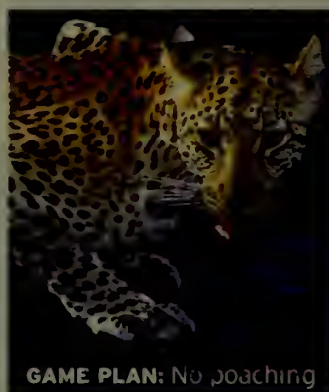
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IDEAS FOR A CHANGING WORLD

Zaire (gold and diamonds). The better answer is that this peaceful democracy has largely stuck to free-market principles, even when its vast diamond wealth could have led it astray. Botswana keeps taxes low. It respects property rights and hasn't nationalized any businesses. It avoids the corruption that easy money encourages, and doesn't waste much money on grandiose air forces or white-elephant industrial projects. Indeed, Botswana is rated Africa's freest economy by the Washington-based Cato Institute in its annual report, *Economic Freedom of the World*.

Back in 1966, Botswana wasn't a model for anything. It boasted just three-and-a-half miles of paved roads and only three high schools in a country of 550,000 people. The per-capita income



GAME PLAN: No poaching

called for a strongman at the head of a one-party state, state-owned industries, barriers to foreign investment and trade, and, inevitably, lots of debt. But Botswana was so poor there was nothing to nationalize and no foreign investment block. And not having any money meant keeping strict controls on government spending.

When diamonds were discovered, a culture of prudent management was already in place, so the money didn't end up in Swiss bank accounts. "Botswana people frown on profligate spending," says Alfred Dube, the nation's permanent representative to the U.N. "The one man every civil servant fears is the auditor-general."

Can Botswana keep it up? That depends on how well it meets two challenges. First, the government has come far too big, critics say, consuming half of the country's GDP, up from just 21% in 1970. So while Botswana ranks only 38th overall in Cato's study on a par with famously overregulated France and South Korea. "More of the diamond money is going into expanding the government," says Eustace Davie, director of the Johannesburg-based Free Market Foundation. "I'm very concerned that in the long run, Botswana won't be able to avoid the curse-of-resources problem, as more and more politicians, bureaucrats, and businessmen hold out their hands for government money." Ambassador Dube worries, too. "I honestly pray we never succumb to that temptation; if we do, the legacy for our children is gone."

That problem, however, pales in comparison to the catastrophe of AIDS. Fully 38.5% of the country's 15-to-40-year-olds are HIV-positive. AIDS is killing many young people that the average life expectancy dropped from 65 in 1980 to just 39 last year. But here again Botswana's culture of prudent management is crucial. It's mounting perhaps the most aggressive counterattack in the developing world, including a massive education campaign and a crash program of upgrading and building clinics and hospitals. Already the infection rate for 15-18-year-olds is starting to decline. The goal is to "get the problem fully under control by 2016," says Dube. As in economics, Botswana's AIDS offensive is a model for Africa. If only the rest of Africa would take note.



was \$80 a year. Water was so scarce, and valuable, that the currency would later be named the pula, meaning rain.

Today Botswana is one of Africa's few enclaves of prosperity. Per-capita income has jumped to \$6,600. In a continent of weak currencies, the pula is strong, backed by one of the world's highest per-capita reserves (\$6.2 billion). Budget surpluses are the norm, and Moody's Investors Service rates Botswana's government bonds higher than Japan's. Botswana's world-class game parks are so free of poachers that they must cull their elephant herds. As a result the government is a leader in the fight to expand legal ivory trading.

Any developing country could have adopted Botswana's sensible policies. But in Africa, most newly independent nations pursued the fashion of the day—socialist or nationalist agendas that

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# Who's Hu?



and would assume the leadership of the party from Jiang as well. Sure, Jiang would probably hold on to his third job running the Central Military Commission. But for Hu, the road to the top was clear. At Beidaihe, officials would start to pay him court. At the Party Congress in the fall, succession would be confirmed—and he would take over as party secretary. By March, he would be President.

Then came Jiang's speech to the Central Party School in May. The propaganda machine started pumping out even more praise than usual for Jiang's theories of communist rule. No political novice himself, Hu knew what was up. After all, this media barrage was so loud that even the lowliest cadre would get the point.

Jiang wants more time running the show. Not as President, but as party secretary—still a position with such power in China that it overshadows every other office in the nation. And Hu? The Vice-President knows the job his boss has in mind for him: President in charge of visiting flood victims and greasing heads of state—an official with no policy clout.

Hu still hopes the party elders can get Jiang to back down—maybe by guaranteeing slots for the President's acolytes on the seven-member Politburo Standing

Committee. Regardless, Hu's not ready to give up. Of course, he can confide his thoughts only to his diary. You can't be too careful when control of Asia's most powerful state is at stake.

## Dear Diary:

Well, Beidaihe was certainly no walk on the beach this year. Comrade Jiang—he had plenty of tricks up his sleeve. And as for figuring out everyone else's agenda—that was practically a full-time job. For starters, what's up with Peng? Isn't he supposed to step down from running the National People's Congress and quit politics completely? Now it looks as if he's planning to retire in name only even though he is. Li wants his guys on the Standing Committee just like Jiang. Everyone knows the nasty riot Li played at Tiananmen Square. Then there are all those questions about his relatives' business

GLOBAL

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Don't know much about China's Vice-President? You might want to take a peek at the guy who's next in line for the top spot

**I**t's Aug. 31, 2002—the end of a long, hard month for Hu Jintao. The Vice-President of China has just returned to the capital from Beidaihe, the seaside resort where leaders of the Chinese Communist Party hold their annual retreat. Things have become a lot more complicated than he expected. Hu, ensconced once more in the official leadership compound of Zhongnanhai, reviews events. Back in the spring, Hu was the unofficial, all-but-designated successor to President Jiang Zemin, 76,

By Dexter Roberts



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dealings. I would want to make sure my men were there to stand up for me, too, if I were in Li's shoes. But is Li backing Jiang's new bid for influence? Or is he neutral? I just can't tell.

Meanwhile, the Taiwanese sure picked an ideal time to mouth off about independence. They may even unwittingly help Jiang hold on to his job. Some of those older cadres who think I'm a milquetoast may not want to switch bosses in the middle of a new Strait crisis.

#### PARTY LINE:

Jiang may wish to retain power, with Hu acting as a figurehead

My elderly critics are not the only ones who doubt me. Even the Western media has called me a "cipher." Doesn't anyone think that the fourth generation has the stamina to run a place like China? The twentysomethings in the cities—who are drifting away from the party in any case—don't want to be ruled forever by the same old bunch.

Besides, have Jiang and his crowd forgotten

everything they know about me? Deng Xiaoping himself anointed me to follow in Jiang's footsteps. Old Deng liked the way I handled myself in the provinces. And when the party needed new blood, Deng appointed me to the Standing Committee—at 49, the youngest member then by a long shot. And Comrade Deng was on the Long March! You want credentials? I have the same alma mater, Qinghua University, as Premier Zhu Rongji. Our polytechnics don't get any better than that.

I know, I know. I've never had an economics portfolio or run a big city the way Jiang did in Shanghai—one of the biggest power bases for any politician in China. They also think that at 59, I'm absurdly young for the job.

Well, I have hidden strengths too. For one, anyone who knows modern Chinese history realizes that leaders-in-waiting and even just-appointed leaders have to keep their mouths shut until they're fully in command. You open up too soon, you take the fall. That's what happened to

Liu Shaoqi under Mao—and Hu Yaobang and Zhao Ziyang under Deng. I'm going to keep head down and stay out of the fray.

Besides, I know how to be tough and keep cool. When I ran the show in Tibet, I imposed martial law. Called in the troops and bashed some heads, too. I didn't enjoy it—but I did it. The cadres think I will sit by and let anyone outside or inside China, tamper with the party. They should just review my record in Tibet.

And I've built up quite the roster of friends and allies after decades of party work. I have plenty of the up-and-coming talent in my camp. Running the Chinese Communist Youth League gave me the chance to spot the best political operators going. Now I have Ling Jihua—used to manage my private office—as deputy director of the general office of the party. Or 45 years old, but Ling knows what he's doing. He's overseeing day-to-day operations of the party organizations—which gives him an inside look at all the machinations. Quite a useful friend to have. And what about my older friend from the Youth League, 62-year-old Zhang Fushe? He's Justice Minister. With all the corrupt investigations being carried out, it's nice to have him on my side. And let's not forget Song Deqiang, another Communist Youth alumnus. If he cleans up that cesspool of corruption in Fujian, where he's party secretary, he'll get lots of credit. Extension, so will I.

Heading the party school since 1992 has helped me fill out my Rolodex, too. I've gotten close to officials who have studied there, year and year out. Even the Western press has noticed how I prodded the school into studying how to reform the party—and even introduce some grassroots democracy. Not too much, mind you, just enough to give the system a little flexibility.

Jiang and his followers may be forgetting one more base of support for me. While Jiang is building his power in several big cities, I'm working in some of the poorest rural provinces: Guizhou and Gansu. I know what an enormous challenge it will be to keep the peasants loyal to the party, especially with grain tariffs ready

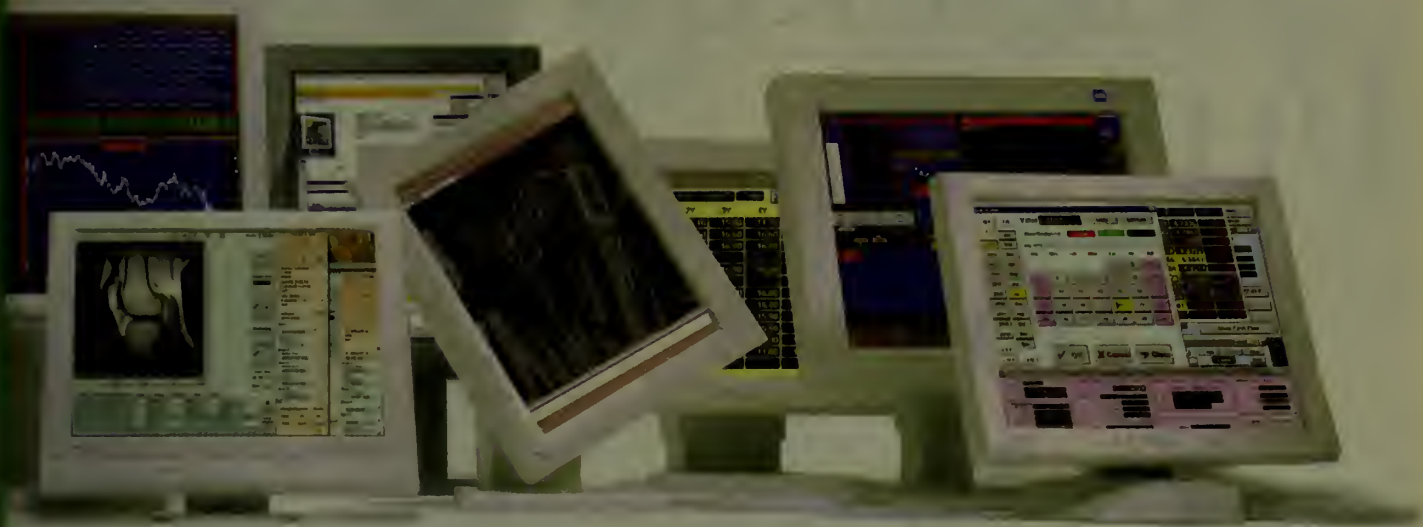
Think he's soft? In Tibet, Hu imposed martial law and called in the troops

to drop. Keeping the lid on rural China is the key to keeping the party in power. The Politburo had better think of that when they figure out whether to support Comrade Jiang—and how much real power to give me.

Hmm. Maybe things will turn out tougher for Jiang after all. By the time the Party Congress rolls around, I may have some more support myself. Of course, I'll be doing it quietly. That's how future leaders in China are supposed to behave.



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# High Tech's Future is in the Toy Chest

# I

By Arlene Weintraub

In a war-ravaged village, an Army lieutenant sets off on a spy mission. As he navigates a dank tunnel on his way to the enemy's hideout, rats scurry around his feet and bats flutter overhead. The bone-jarring rumble of a passing enemy vehicle shakes rocks loose from the bloodstained walls. Watchdogs soon spot him and bark furiously, causing his heart to race.

Luckily, the scenario isn't real. It's DarkCon, a virtual-reality video game being developed by the U.S. Army-backed Institute for Creative Technologies (ICT) at the University of Southern California, which aims to create total-immersion military training tools. The bats, rats, enemy soldiers, and even the heartbeats are digitally rendered. But not the trainee's emotions: fear, doubt, revulsion. "That's what we have to capture to make a game that teaches something useful," says ICT creative director Jim Korris.

Why did the Army back ICT—an eclectic group of video game makers, tech PhDs, and Hollywood producers—to develop the next generation of military training tools? Because they realized that the cutting edge for such technology exists not in the labs of Silicon Valley but in the electronic games and toys strewn about the rooms of 10-year-olds everywhere. "They've embedded Newtonian physics into most of the [new games], so when a weapon drops to the ground, it bounces and slides properly," notes Greg E.

TECHNOLOGY

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Toymakers are pushing the boundaries in artificial intelligence, wireless communications, and virtual reality. And the benefits are flowing to other industries as well

Blonder, a venture capitalist at Morgenthaler Ventures. "That's really impressive." At the Massachusetts Institute of Technology, Michael Hawley, director of special projects, says, "Toys are sparkplugs for the imagination. They'll drive technology development into the future."

Indeed, toy inventors are pushing the boundaries of artificial intelligence, speech synthesis, wireless communications, and networked virtual reality. What's more, they are figuring out how to cram huge chunks of realistic graphics, dialog





sensory cues onto tiny, inexpensive computers. That's what enables the toy steering wheel for the video game *Grand Turismo 3* to pop when an on-screen race car jumps an obstacle. It's what allows Fisher-Price's robot Kasey Kinderbot to do the hokeypokey, with dexterity some factory robots might envy. Robotics provides some of the best examples of how the military has tapped into the creativity behind toys. In July, the Defense Advanced Research Projects Agency (DARPA) handed a \$5.5

**E-VOLUTION:** Robot pets can interact "in ways that appear intelligent," says one VC. Someday they'll work together, not just as toys but in factories and offices

million grant to Carnegie Mellon scientists who are designing a robotic Humvee—inspired by a toy car—that can climb on top of obstacles and other vehicles, and right itself if it flips over. "We're trying to extend the idea to a large vehicle," says John E. Bares, director of Carnegie Mellon's National Robotics Engineering Consortium, who submitted a video of his son's Tyco Super Rebound in his DARPA grant application.

Other industries are benefitting from innovations in toys. The technology that adds sensory



effects such as bumps and rumbles to games, for example, has been built into machines that train medical students. Sony Corp.'s robotic dog, Aibo, is poised to evolve from a toy-like playmate to a bona fide home-office assistant. The latest models can film streaming video or download their masters' e-mail wirelessly from their PCs. Eventually, such robots may work in teams, Blonder observes. "You can now have groups of [toy] robots that interact amongst themselves in ways that appear intelligent," he says. "That kind of collective behavior is going to be used for tasks, as opposed to entertainment. These are still the early days."

Toymakers are sought-after industrial partners because they speed the development of new technology and do so affordably. Americans spent more than \$11 billion on video games, consoles, and electronic toys last year, according to industry researcher NPD Funworld. But most moms won't shell out thousands of dollars for a plaything. So at Fisher-Price, the inventors of Kasey the robot used specialized speech-compression techniques to increase the content on a standard audio processor nearly a hundredfold. The \$75 robot can lead preschoolers through more than 80 hours of songs, games, and lessons.

Game consoles, meanwhile, pack the latest advances in fast data transfer, graphics, and audio processing into boxes that cost just \$200. The internal hard drive on Microsoft Corp.'s Xbox, for instance, can store parts of a game as it's playing out, then regurgitate it for special effects, such as instant replay, complete with personalized commentary. "You can go back and see all the shots you made and missed," raves 13-year-old Clayton Schoeny as he plays *NBA Live 2002* on his Xbox in Redondo Beach, Calif. "You can see the entire game in slow motion. It's crazy."

Consumer demand fuels ever more innovation. Gamers weren't content to sit alone in their dens hunting dragons or creating fictional cities. So publishers started building entire fantasy worlds in cyberspace and hosting thousands of players in so-called "massively multiplayer" games. Building a network backbone robust enough to support these cyberworlds has forced the world's top tech companies back to the drawing board. IBM, for example, is devising a novel class of computer chips that can manipulate data and produce images on the fly, based on the commands of thousands of online gamers simultaneously. "We started with a totally new way of thinking," says Bijan Davari, vice-president of semiconductor research and development for IBM.

The advances in silicon for toys can produce startling results, prefiguring future applications for offices and factories. Consider Electronic Arts' upcoming *The Sims Online*—the Internet version of the video game that allows players to construct fictional suburban lives. Players will interact with one another rather than with the drab computer-generated people in the offline

version. Each region of the game, which appear this fall, will be able to support 2,000 players at a time. They'll work together through their on-screen Sims counterparts to start businesses, build bridges, and perhaps even fall in love. Real-world applications are likely to follow—starting with the military, which is looking at similar technology to conduct online team exercises involving troops all over the world.

Virtual sensations are another important spin-off from toys. Video games were some of the first commercial products to incorporate so-called force feedback—the use of vibrations and other sensory cues to simulate the feeling of, say, a machine gun recoiling or a tennis ball hitting the sweet spot of a racket. Immersion Corp. in San Francisco, which licenses such technology to others, is finding a growing market outside the gaming industry. In medical training applications, machines can replicate the sensation of pushing

Video games were among the first products to use vibrations to simulate a gun's recoil or a tennis ball hitting the sweet spot

a needle against the arterial wall, using sound and motion to create different scenarios—a wailing baby, perhaps, or a patient in pain. It's a far cry from old techniques, like sticking needles in plastic arms and oranges. "The neat thing is that you feel the give and take," says Adam Levi, assistant professor at Mt. Sinai School of Medicine in New York, which uses Immersion's simulator. "It's as if you were piercing through real human tissue." With sound, sight, and touch accounted for, the next big frontier may be virtual smell.

Ultimately, technology from toys could transform the way business is conducted in every industry. Companies that use virtual reality training today may one day employ game-like shared simulations hosting thousands of workers simultaneously. And robots could assist the sick or elderly. Last year, a dozen robots combed the wreckage of the World Trade Center looking for victims. "This proves that robots can be useful," says Hiroaki Kitano, who heads a government-funded robot R&D project in Japan.

Children growing up with the seeds of this technology constantly push it forward. At the Carnegie Mellon Robotic Autonomy course this summer in Moffett Field, Calif., Leticia Cabrales, 17, built *SpongeBots*, a special robot that runs, walks, and dances. "What if a robot could sense and feel, as we do," she asks. It could help the disabled, she muses—and better yet, it might actually want to. As a youth and an inventor, Cabrales straddles an important line. Tomorrow's most innovative technology is in the minds of children—and the creative inventors who continue to dream up remarkable ways to entertain them.



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# Vaunted Technologies That Don't Measure Up

*Financial statements signed by auditors aren't the only things that don't always deliver what they promise. Our society is awash in technologies that aren't as reliable as people tend to think. Sure, it would be naive to demand that our innovations perform perfectly. But consider the following. In courts, fingerprints are a primary tool for separating the guilty from the innocent—even though nobody knows for sure how accurate fingerprints really are. On computer networks, firewalls are sup-*

## TECHNOLOGY

# 17

*posed to protect us from evildoers. But they may actually increase vulnerability by stilling a sense of security that the technology can't remotely guarantee. The predictions computer models can be way off target. Another 15 years in development, HDTV is still the future that never comes. We should know limits of current technology before blindly embracing such next-generation concepts as digital ID cards. Here are examples of technologies that merit a skeptical review:*



## STEALTH AVIONICS

**T**o hear Northrop Grumman Corp. tell it, the B-2 Spirit stealth bomber is nearly invisible. It's "able to penetrate hostile space without being detected," the company boasts on its Web site.

Further, it does not need an armada of support aircraft to accomplish a mission." Why not? The plane's composite materials and bat-shape design make it hard for radar to pick up.

So why were the \$1 billion B-2s flying in

the Balkans and Afghanistan accompanied by planes stuffed with electronics for jamming radar? It turns out that "stealthy" is a pretty relative description—as the U.S. Air Force discovered in 1999, when an F-117, which also has a stealthy shape and materials, was blasted out of the

sky over the Balkans.

Stealth technology is hardly a sham. It shrinks the radar "signature" of a plane. If a conventional aircraft makes a blip on radar screens at 200 kilometers, a stealthy plane wouldn't appear until it was 34 km away. The point is, radar does eventually detect the plane, as do in-

frared devices—plain eyes and ears.

Weather can present a problem. B-2's materials were tested at Edwards Air Force Base, where it rarely rains. But when the high-tech bomber got drenched during missions in the Balkans, the tape used to seal the seams in the composite skin often came



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loose. That enlarges the radar signature.

So for now, the American military has taken to escorting B-2s with planes armed with radar jammers and missiles that can take out enemy radar sites. The bombers are capable of flying some of their runs alone—but only after radar and anti-aircraft weapons have been destroyed. Trouble is, both sides can play at stealth. Serbian forces were careful to use radar sporadically, effectively hiding it and preventing the U.S. from knocking out all the listening posts—and thereby

curbing solo flights of B-2s.

All of this raises questions about the Air Force's plan to replace much of its existing fleet with stealthy aircraft such as the F-22 fighter, whose \$99 million price tag is twice that of a conventional F-15. That's why the Navy rejected a stealth design for its new F/A-18 fighter, opting instead to rely on jamming. Less reliance on stealthy designs would free cash for more airborne jammers. They may be older and less sexy, but they still get the job done. *Stan Crock*

## NETWORK FIREWALLS

Firewalls on computer networks are like river dikes: One bad breach can bring catastrophe. Networks of Citibank, eBay, the Defense Dept., and other organizations scanned thousands of times a day by hackers. Firewalls fend off 99% of these malicious probes. But eventually, a few get through.

So if a firewall is the only protection for the family jewels, they're in jeopardy. In some cases, "the firewall is rendered irrelevant," says Bruce Schneier, founder of Counterpane Internet Security Inc. Skirting it may be as simple as finding an unprotected network device such as a fax machine or a copier. These are often wired to exchange messages with their manufacturers—and manufacturers can be impersonated. Hackers can also penetrate the network of a target company by wiggling through its undefended Internet links with partners, suppliers, or customers. In short, the burden is on the company to make its entire network bulletproof. Too many hackers these days pack machine guns.

*Roger O. Crockett*



## FINGERPRINT ANALYSIS

A defendant's fingerprints match those found at a crime scene. His goose is cooked, right? After all, no two people have the same fingerprints.

Or do they? Nobody really knows. The statistical data needed to analyze the chances that there are two identical fingerprints haven't been collected. But no matter how astronomical the odds turn out to be, fingerprints are no longer quite the courtroom clincher that they used to be.

The reason stems from two court cases on opposite sides of the Atlantic. In Scotland, forensic investigators in the late 1990s found what they said was a police officer's thumbprint in the house where a woman had been murdered. Subsequent events

showed that the fingerprint was neither from the officer nor from a thumb (it was

from a forefinger). While everyone acknowledges that crime-scene prints are typically small, smudged, and hard to identify, the Scotland

fiasco points up the fact that matches are made by people—and people sometimes make mistakes.

Partly on that basis, federal judge Louis H.

Pollak sent shivers through the American justice system last January. In U.S. District Court in Philadelphia, he ruled that experts from the FBI wouldn't be allowed to state unequivocally that any crime-scene fingerprint belonged to one of three alleged drug dealers accused of being involved in four murders. The feds appealed, of course, and persuaded Judge Pollak to reverse himself in March.

Still, it's now part of U.S. legal lore that the criteria for declaring two prints to be a match vary wide-

ly. As Judge Pollak learned during hearings, Italy demands at least 16 identical features or patterns, while Scotland requires only 12. The FBI does not have any such standard; instead, it relies on two or more fingerprint examiners who agree there's a match.

In persuading Judge Pollak to reverse his January decision, the FBI insisted that its fingerprint-match procedure has never incorrectly nailed a suspect. But how would we know? Law enforcement agencies were just as confident of the evidence that convicted scores of people who were later exonerated when modern DNA evidence came available.

Are there people in prison who were convicted on the basis of faulty fingerprint matches? Could be. It's an uncertainty we'll have to live with for a while longer. *Otis P.*







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## HDTV

Was there ever a high-tech policy debacle like high-definition TV? When it works, the technology delivers near-perfect digital pictures, stunning six-channel sound, and a host of interactive features. But the warring interests that want a piece of the new market—or see it as a threat—have

turned America's digital makeover and its 2006 deadline into a joke.

Local TV stations say HDTV broadcast equipment is expensive, content is limited, and the technology doesn't work well enough to reach most homes without an extra antenna or cable or satellite gear. Hollywood studios argue it works too well, that the pristine digital content will prove irresistible to pirates. TV

and set-top box makers, meanwhile, say the market is already being garroted by too many costly and ill-conceived copy-protection standards. "If I can't figure [all this] out, how can the average person?" laments Chris Cudina, senior marketing

manager at Samsung Electronics Co.'s digital set-top box division.

Consumers seem attracted to HDTV sets as an enhancement to their DVD-equipped home theater systems. And it's true: DVDs look great, but real high-definition should look even better. Will we ever get to see it? Do consumers care if the answer is no? Either way, the 2006 deadline is bound to get lost in all the noise. *Cliff Edwards*

## ENCRYPTION

Movies on DVD were supposed to be copy-proof. So why are illegal copies getting stamped out faster than *Halloween* se-



quels? European hackers discovered a hole in the costly software code that Hollywood baron to thwart movie pirates. One software licensee inadvertently neglected to encrypt a "key" that unlocks DVD movie disks. Now, the key is easily found on the Internet—meaning that almost any PC can be turned into a part-time moviemaking machine, cranking out perfect digital copies. "That's what really scares the motion-picture makers," says P.J. McNeilly, a research director with information-technology researcher GartnerG2. Properly implemented, encryption can be virtually impenetrable. But too often, human frailties gum the works by leaving unforeseen breaches in otherwise secure systems. This explains why many protection schemes get "hacked" in a matter of days," says John M. Jordan, a technology expert at Cap Gemini Ernst & Young.

*Roger O. Crockett*

## FACE RECOGNITION

The scenario has been played out in countless action movies: Computer geek sits in a darkened room staring at a screen. He gets an alert that a camera nearby has matched a face in the crowd with some miscreant in his database. Next scene: FBI agent accosts the bad guy. Is it any wonder we think technology can protect us?

Sadly, Hollywood's imagination is way ahead of the technology. While some airports and communities, such as Virginia Beach, Va., and several British cities are deploying face-recognition technology, public tests have been disappointing. In the first half of an eight-week test in Palm Beach International Airport, a system using software from Identix Inc. failed 53% of the time. In a 90-day test at Boston's Logan International Airport, consulting firm Counter Technology Inc. found that systems from Identix and others produced too many alerts—many of them false alarms. The problem: Differences in lighting and angles between the video image of the real person and photos stored in a database.

Identix blames its low scores on faulty installations. If the system is correctly calibrated, it is 98% accurate, the company claims. Vendors also stress that the technology has some uses that few experts criticize. It works well when people stay still, or small groups are herded through control points, says Michael Thieme, director of special projects at International Biometric Group, which completed an extensive study for the Transportation Security Administration in June. This approach may be suited to casinos, but isn't practical for high-traffic airports or street corners. For such fluid environments, the technology "is so far away from working, it's hard to say when it will be widely deployed," Thieme says. But Hollywood can always dream.

*Heather Green*





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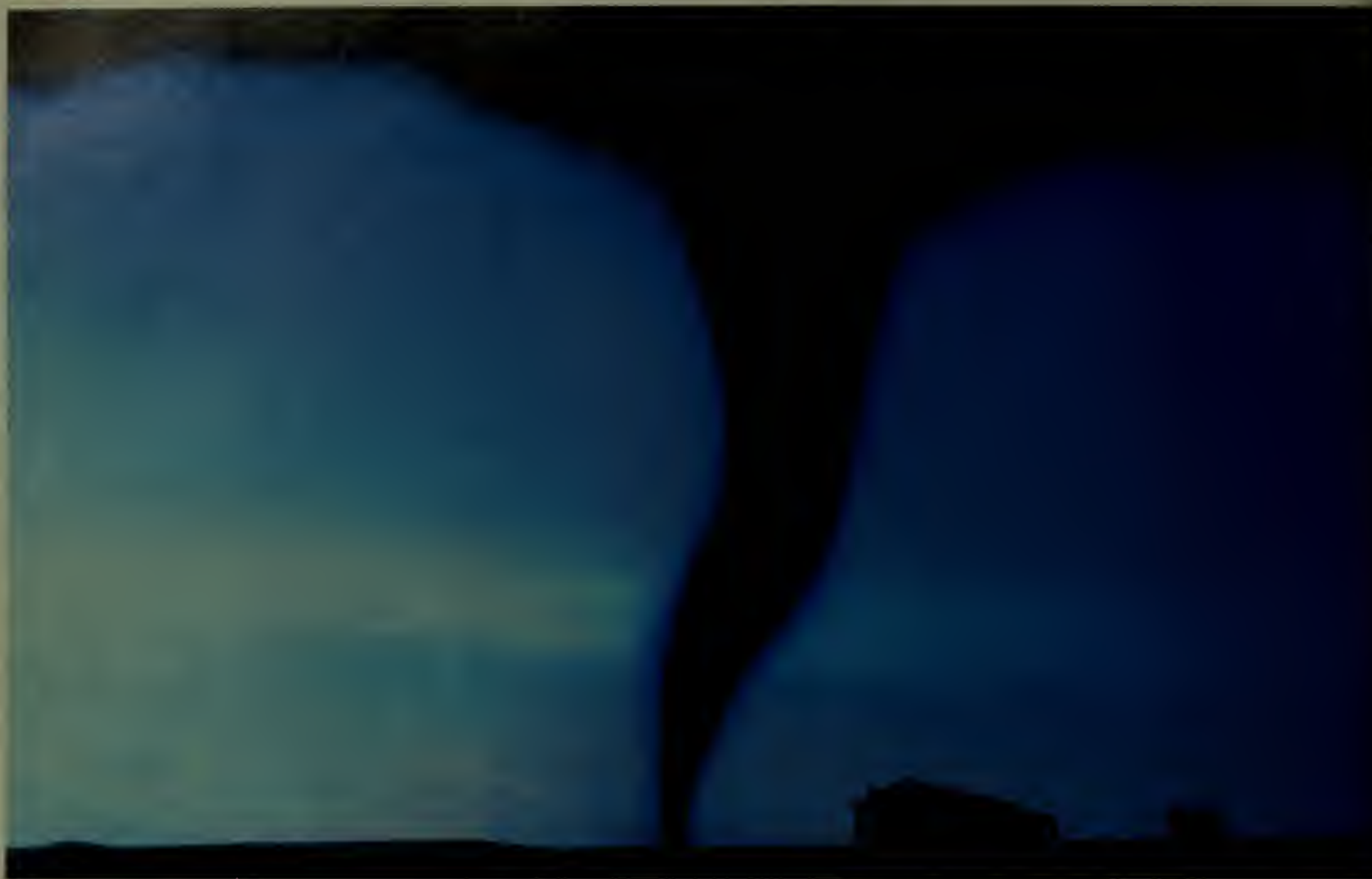
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## COMPUTER MODELS

**M**arch weather is notoriously fickle. That's why weather forecasters keep an eye peeled for portents of snowstorms like those that periodically paralyze the East Coast—including 1993's "storm of the century," which dumped three feet of snow on some states.

In early March, 2001, weather computers were warning of a repeat storm of the century, with even deeper snow. But the fateful day, Mar. 6, came and went with less than a foot of snow in urban areas.

What went wrong? Blame it partly on "shortcuts" in computer models. Today's supercomputers can't crank through all the

calculations required to generate better forecasts—at least not before the bad weather hits.

So simulations use clever algorithms that gloss over certain details. Avoiding such shortcuts "won't happen any time soon," says Jimy Dudhia, a physicist at the National Center for Atmospheric Research. Doubling the detail in three-dimensional weather models, he explains, would take eight times more number-crunching power. Even then, the model would be too coarse to predict tornados accurately.

Many computer models used in biology, chemistry, and physics also rely on shortcuts. Otherwise, answers might not

pop out for months or even years. For example, atom-scale simulations based on all the gory details of quantum physics are impractical for more than 300 atoms. Michael L. Klein, director of the University of Pennsylvania's Center for Molecular Modeling, struggles to run simulations involving just 200 atoms because even a few picoseconds' worth of a routine chemical reaction take an hour to model, even on a top supercomputer.

So, when computer simulations promise quick and faithful imitations of complex real-world phenomena, experts should be sure they understand what's built into the shortcuts. Being too trusting could lead to fizzles like the storm of the century that wasn't. *Otis Port*

## NATIONAL ID CARDS

**T**he feds are toying with schemes for hi-tech national ID cards—as if this will separate the good guys from the bad. Wrong. All the cards will deliver is a false sense of security. You can stuff them with chips and even throw thumbprints or digitized retinal scans. But the document they're based on—birth certificates, passports, or whatever—are forged. A thumbprint is no better than a picture.

Despite that, some companies already insist that workers carry smart IDs, with chips containing birth dates, Social Security numbers, addresses. The Transportation Dept. also wants smart IDs for every truck driver, port worker, flight attendant, and train conductor. And Congress is set to approve a homeland-security bill that would mandate chip-enhanced state driver's licenses, standardized across state borders and backed by birth certificates. But don't let the silicon fool you: Identity is all too easy to fake. *Lorraine Woellert*



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## CRASH TESTS

**M**y brother asks me: "I want the safest car I can get. What should I buy?" I resist the urge to recommend a tank. Short of that, though, the answer starts to get complicated.

Most safety-minded consumers rely on the crash-test results from the National Highway Traffic Safety Administration ([www.nhtsa.gov](http://www.nhtsa.gov)). Pick any car or truck with a five-star rating, and you're fine, right? Not exactly. There's a lot these crash tests don't tell you—starting with what happens in the event of a 90-degree side-impact collision.

Safety advocates are pushing NHTSA to run such tests, which are standard in Europe and Japan. Other uncertainties abound, however. NHTSA's head-on crash tests show only how a vehicle would fare if it hit another vehicle of similar size. That doesn't tell you what happens when a large vehicle hits a smaller one—the occupants in the small car are far more likely to be killed. Indeed, the weight of the vehicle is the single most important factor in determining occupant safety.

That helps explain the popularity of big trucks and sport-utility vehicles. But bigger isn't always better. The higher ground clearance that trucks and SUVs need for off-road use gives them a higher center of gravity, making them more likely to roll over if the driver runs off the road.

So what did I advise my brother? Forget about that big pickup truck, and look instead at large cars, vans, or the new breed of "crossover" SUVs: They're less prone to roll over because they're built on a car chassis. Load up on all the safety and handling options available, including side air bags, antilock brakes, and traction or stability control. And of course, fasten your seat belt.

*Kathleen Kerwin*

## DIGITAL ARCHIVES

**T**oday, you buy a house and get a deed on paper. It will probably still be readable a couple hundred years from now. But more and more records—legal, government, and corporate—are being created as digital information that never exists on paper, and doesn't last nearly as long. If deeds become digital-only documents, will people still be able to prove they own their homes two decades after they buy them?

Digital documents have a variety of limitations, some of them severe. In the case of computer hard drives

and tape, the magnetic charge that distinguishes a one from a zero gradually degrades and can turn into gibberish in as little as 10 years. Similarly, physical changes affect compact disks, although more slowly. Some have lifetimes pegged at 30 to 100 years.

Then there's the playback hardware. Even if the storage medium remains in good shape, it may not be readable by modern equipment. The digital tapes containing the 1960 U.S. Census Bureau, for example, can be read by only one machine in the U.S.—in the

Smithsonian Institution. Or the data have been recorded using software like the CP/M operating system that preceded MS-DOS. Windows, is all forgotten.

One common solution is to regenerate data periodically, recording it on modern media with current systems. But even that has a hitch: When transferring data, there's always the risk of a hiccup that can turn a zero to be copied as a one. The best practice, according to the National Institute of Standards & Technology, is to keep digital media at 65°F and 40% humidity, and most will last several decades at least.

*Otis*





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# The Coming Battle For Immigrants

By Stephen Baker

It's a long-standing tradition in Colmenar Viejo, a suburb of Madrid. As the sun sets, old folks make their way to the benches in the central plaza. It's a perfect place to watch children play and teenagers flirt. This summer, the benches are as packed as ever. But one thing has changed: Hardly any kids are mulling around.

The scene on the plaza is a poignant barometer of one of the most profound trends sweeping the industrialized world: the graying of the population. Due to plunging birth rates, the number of children under 15 has shrunk by 23% in Europe since 1970. And the shift will continue. There still are four working-age people to support every European aged 65 or older. In a few decades, predicts the U.N. Population Div., that

WORKPLACE

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**The ability to absorb foreigners could determine whether nations in the industrialized world will grow or stagnate**

number will fall to two. The pattern is just dramatic in Japan and Korea, and to a lesser degree in the U.S. A few decades hence, big developing nations like China, Russia, Brazil, and Thailand also will see a surge of retirees. By 2050, the average age of the world is expected to rise from 26 today to 36. In Spain, the average age by mid-century should hit 55.

The economic implications are huge. Who will do the work in geriatric societies? Who will support the burgeoning class of pensioners? And what will happen to growth? After all, in addition to productivity, a rising labor force is a key ingredient of economic expansion. Harbingers of a stagnant future already are seen in Japan and in Italy.

Wealthy nations have another choice: to import workers on an unprecedented scale. That's essentially what the U.S. has been doing for the past two decades as the baby-boom generation matures. The U.S. takes more than 1 million immigrants annually, including illegals. That is a key reason economic growth has averaged 3.7% a year for the past decade. Immigrants have su

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plied crucial technical and scientific talent, founded thousands of Silicon Valley startups, and helped hold down prices by filling low-wage jobs.

If the rich nations other than the U.S. choose to keep immigrants out, they will have to achieve radical gains in productivity to keep their economies from hitting a wall. According to one estimate, Europe must boost its productivity by two-thirds before 2020 just to keep its economy from shrinking. But that requires investment in labor-saving machinery and new plants. "And who will invest in these countries if their markets are shrinking and they won't have an adequate labor supply?" asks Paul S. Hewitt, co-author of a two-year study of the economic impact of global aging by the Center for Strategic & International Studies in Washington.

To escape this vicious cycle, governments outside the U.S. are starting to reconsider the immigration question. Officials in South Korea, which has tight controls on foreigners, say they want to dramatically increase the number of three-year work permits. Currently, 266,000 Chinese, Filipinos, Bangladeshis, and other foreigners work illegally in everything from fisheries to construction sites. Many Taiwanese businessmen, who now are shifting manufacturing to China, hope relations with the mainland will warm so that they can recruit that nation's enormous pool of engineers and laborers. And in Europe, corporations are lobbying for more freedom to hire foreigners. "We have full employment here [in the Netherlands], and companies can't find workers," says venture capitalist Roel Pieper, a former Royal Philips Electronics and Compaq Computer Corp. executive. "Yet politicians want to close the door."

Pieper is right: While many policymakers and executives see the advantage of welcoming immigrants, the rest of society tends to see them as a threat. Outside the U.S., few countries have the laws and administrative capabilities—let alone the desire—to absorb so many foreigners. In Europe, political pressure is growing in the opposite direction. The recent electoral success of hard-right politician Jean-Marie Le Pen in France is largely because of his anti-immigrant stance. Curbing immigration is a key issue for

the Netherlands' List Party. It placed second in May legislative elections—even after its leader, Pim Fortuyn, was gunned down.

To be sure, immigration isn't a complete solution. For one, the numbers would have to be astronomical. Germany would have to boost migration twentyfold and Japan fiftyfold to offset the population implosions," estimates Sylvester J. Shieber, research director for the power agency Watson Wyatt Worldwide. "That just isn't going to happen." Even maintaining current inflows, the U.S. will likely face labor shortages by 2010.

Governments can also urge women to

more children. China ended its one-child policy. But few nations have succeeded in persuading women to bear more children once they have accepted birth control, jobs, and an urban lifestyle.

Another option is to extend the retirement age. Only 40% of people age 55 to 64 now hold a job in Europe, for example, thanks to generous early-retirement programs. But expanding the number of older workers solves only part of the problem: Economies need young workers to support families and form households. Another strategy is to get more women into the workforce. Take South Korea, where a sharp plunge in births from 4.5 to 1.4 means the elderly population is expected to double by 2020. The pension system could go bust by next decade if benefits aren't cut, predicts Korea Development Institute researcher Hye Hoon. Currently,

of women work. Seoul wants to raise that to 60.

In most countries, such strategies will only marginally ease a huge, looming labor crunch. And if they rely on temporary work visas, countries will have enormous populations of second-class citizens, a recipe for social strife. At some point, politicians in each developed economy will have to confront the overwhelming need for more immigrants. Cultural purists will be outraged. Unionists will take to the streets. The ability of societies to absorb foreigners could well determine which economies will grow in the rest of this century—and which will fade into the twilight.

With Moon Ihwan in Seoul, Pete Engardio in New York, and Aaron Bernstein in Washington

**GERMAN FACTORY:**  
Will Europeans have to work longer?



## The Looming Demographic Crunch

As the Global  
Population Grays...

...There Will Be Fewer  
Workers to Support Retirees





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# Rethinking the

**A**mericans take an almost masochistic pride in long hours. To be busy is a sign of importance. The harder you work, the higher you rise. Vacations are the stuff of long weekends and an occasional seven-day stretch. A 35-hour workweek is for the French or some other culture that sips wine at midday. In the U.S., it's all about what you do—not who you are. And those who sleep five hours a night or juggle two seemingly full-time pursuits evoke envy, not sympathy.

By Diane Brady

High tech, which was supposed to free people from the office, has in practice eroded the boundaries between work and leisure. There's no haven from e-mail and the telephone, no excuse not to produce at any hour of the day, and no obstacle to turning your kitchen table into a work station. With fewer than one-third of Americans working a traditional 9-to-5 day, even rituals such as the family dinner are disappearing.

But there's a payoff. To cope with a world where job descriptions are going to become even more all-encompassing, both workers and employers are starting to redefine their notion of work. The social contract is changing as a fluid schedule demands more flexibility from everyone in the workplace. Face time at the office has become increasingly irrelevant in climbing the corporate ladder. Instead, output and productiv-

## WORKPLACE

# 19

Technology is making "all work and no play" a real possibility. How will we strike the proper balance of work and life?

ity are the gauge of success. For John A. Challenger, CEO of workplace consultancy Challenger, Gray & Christmas Inc., the blurring boundaries are liberating rather than enslaving. "We've been shackled by the idea of 9-to-5 since the early part of the last century," he says. "Today, we're much freer to go home and fit work around our needs."

Even if Americans can't bring themselves to take more official time off from the job, they increasingly will demand that the job be more accommodating to their personal time. The workweek may be broken up into three-hour chunks of time spread around the clock or compressed into an intense three-day period. Each employee will operate on a different internal clock, and employers will be more attuned to what actually constitutes productivity.

Already there are signs that Americans are starting to find more balance. As job time has encroached on leisure time, so too has leisure crept into the job. Workers increasingly are Internet shopping, exercising, chatting with friends, or otherwise building breaks into their day. They may work at midnight, but they also feel free to take off at 3 p.m. to see a child's school play. The aging of the workforce and the need for constant education are creating a rigid view of careers—one that lets people in and out of the job market, work into the 70s, or take time off in their 30s to study, travel, or raise children.

Smart employers are restructuring the workplace to accommodate the shifting boundaries, enabling their staff to be more productive at home and find more fulfillment at work. Even salaried employees may increasingly be treated as independent agents who define the parameters of their workday. And the office could morph into more of an extension of private life. SAS Institute Inc., the world's largest private software company, Cary, N.C., has brought everything from nu-

## America the Industrious



Data: World Tourism Organization

\*INCLUDES PUBLIC HOLIDAYS

# t Race



choice between two weeks of extra pay and two weeks of vacation, Americans would take the vacation by a margin of 2 to 1. "People are feeling overloaded," says President J. Walker Smith. One reason may be a demographic shift, as the massive baby boom generation enters a life stage in which making money becomes less important than family and personal pursuits. While an uncertain economy has left many workers worried about their jobs, September 11 underlined the fleeting emotional payoff of bigger paychecks.

Still, the U.S. work ethic is tough to shake. While much of the developed world has cut back the annual number of hours worked per person over the past decade, Americans have headed in the opposite direction—adding 58 hours to their yearly total. The Japanese, by contrast, have cut more than 191 hours. Yet U.S. workers don't even take what few holidays they get, giving back an average of 1.8 days, or almost \$19.5 billion total, in unused vacation time to employers each year, according to a survey commissioned by online travel agent Expedia.com.

Indeed, complaints about work stress have become almost a badge of middle-class honor. Parents overschedule their children almost as much as themselves. "To keep busy is a mark of prestige in our society," says Bradd Shore, director of Atlanta's Emory Center for Myth & Ritual in American Life.

At the same time, the high cost of overwork is fast becoming evident. Medical studies show a correlation between a lack of vacation and increased heart attacks or other illnesses. Long hours also take a toll on productivity. Some studies even suggest that the vacation-loving French and Belgians now outproduce Americans on a per-hour basis. "At a certain point, there's a negative rate of return," says

Lawrence Jeff Johnson, a senior executive at the International Labor Organization in Geneva. "If people work longer hours, they don't have time to refresh." He ought to know: After five years of living in Europe, the U.S.-born Johnson still hasn't adjusted to six weeks of annual vacation. In his first two years, he took two. Now, he's lucky to take three or four. "It's my Midwestern work ethic," he admits.

With fewer boundaries to delineate time off, the risk of burnout can be profound. But the value of a balanced life is also becoming more clear. After all, in a complex and increasingly competitive global economy, the well-rested—and productive—worker is king. ■

...n counseling to youth day camps into the office environment. Sick SAS workers visit onsite medical facilities. The company's 4,000 employees bring 700 children to day care and, next year, could be able to enroll them in an SAS kindergarten. Working at home or putting in odd hours is the norm. "It's all about trusting employees," says human resources director Jeff Chambers, returning from a Florida beach. "We want people to have a challenging worklife and a life outside work."

That's a big challenge for Corporate America. Many employers would rather dole out stock options or bonuses than time off. Yet a study byinkelovich Partners Inc. shows that given the



# Welcome to the Health-Care Economy

HEALTH

20

As time catches up with baby boomers, spending on medical care will skyrocket and set off a vast shift in the nation's resources. New investments in health could be a major engine of future growth

G

By Howard  
Gleckman

et ready for the blossoming of the New Economy. No, not that New Economy. Information technology may have been the driving force behind the 1990s boom, but in the coming decades, Americans' standard of living will be linked inextricably to a very different trend: a surge in health-care spending. Forget dot-coms. Think little green pills and home health aides. The U.S. is facing a new world of medicine driven by innovation and the needs of aging Americans for ever-more-intense levels of care.

Already, the U.S. spends \$1.4 trillion, or 14% of its gross domestic product, on medical care. That's almost twice what it pumps into info tech. Within a decade, however, it could be spending close to \$3 trillion, or a staggering 17% of total national output, on health. If that growth continues unabated, medical care by mid-century will absorb almost one-third of the economy.

The consequences of this shift of resources will be enormous for companies, workers, and the government. It will mean a massive transfer of the nation's income—whether profits, wages, or tax dollars—to medical care. "The transformation will be as big as anything the computer has produced," says Harvard University economics professor David Cutler.

This shift has enormous potential benefits. It will generate a boom in well-paying health-care

jobs. It will provide opportunities to develop new technologies. Billions of dollars will become available for advances in biotechnology, medical devices, and fresh techniques to prevent or control disease. Many of these new products and services could lead to a spurt in exports. Most important, all this spending should make America healthier.

But these exploding costs could have severe negative consequences. Businesses will have to rethink the way they spend their resources since every dollar devoted to health care will be a dollar not available to augment profits, purchase productivity-enhancing equipment, or hire workers. Employees will face an increasingly stark situation: The more they receive in on-the-job health benefits, the less they'll see in wages, pensions, or vacation time. Without continued productivity growth, the recent rise in real incomes will come to an end, and the nation will become markedly poorer.

Government will wrestle with similar choices. Washington and the states are facing an era in which providing health care for the elderly and the poor could come to absorb nearly all the revenues. By mid-century, two-thirds of the entire federal budget will be spent on medical care, estimates the U.S. General Accounting Office. That is as large a share of tax dollars as Washington has ever pumped into any program since one: fighting World War II. The exploding expense of Medicare, the health program for seniors, and Medicaid, which provides care for the





, represents "an unsustainable burden on re generations," warns U.S. Comptroller eral David M. Walker.

Why is this big hike in health-care spending so blesome? Think of it this way: Most of us d breathe a great sigh of relief if we learned the current slump in IT spending were about d and that business would once again pump s of money into computers, telecommunica- s gear, and software.

nation would look ard to another '90s- era of booming capi- spending, powerful luctivity growth, and ng corporate profits. y contrast, predic- s of huge increases

alth-care spending produce a very different tion: sweaty palms. While there is broad ement that IT is a valuable investment, com- atively little is known about the benefits of th spending. In tight labor markets, CEOs ngly authorize medical outlays as a nec- ary evil—the cost of hiring and retaining rkers. But few view it as enhancing produc- y—the key to making everyone wealthier.

"The bang from IT is not only more palpable. It is quicker," says Mark Zandi, chief economist at Economy.com Inc. "Health-care benefits are reaped over a long, long time."

If CEOs are looking at traditional measures of economic growth, it's no wonder they fret over runaway medical costs. The productivity of the health-care industry grew at an annual rate of just 0.7% from 1995 to 2000. That's pitiful

{ A handful of economists now view health care as an investment, no different from purchasing equipment or training employees

compared with the 2.6% annual rate for the rest of the economy. And as medical care becomes an ever-larger share of the nation's spending, that lagging performance threatens to drag down the long-term growth of the entire economy.

But recently, a handful of economists have begun taking a different view. They look at health care as an investment, no different from purchasing equipment or training workers. From



that perspective, health care has the potential to give the economy a huge boost.

Some benefits are easy to see. Just look at the transformation of once-gritty industrial cities such as Birmingham, Ala., and Pittsburgh—now centers of medical care and health research. The Labor Dept. forecasts that through 2010, health-care jobs will increase faster than any other occupation except data processing. Opportunities for registered nurses, for instance, are expected to grow 58% over the decade.

Moreover, dramatic advances in technology have the potential to generate big bucks in industries such as biotechnology and medical devices. For instance, the Food & Drug Adminis-

tration estimates that as many as 3 million Americans could benefit from an implantable fibrillator, a device that helps maintain a steady heart rhythm. Products such as this could also be sold to millions of other heart patients around the world, boosting exports. At companies such as General Electric Co., medical equipment accounts for 9% of profits and, even in a soft economy, sales are rising at double-digit rates.

The biotech industry, dominated by the U.S., holds similar long-term promise. With an estimated \$60 billion worldwide market for biotech products, the opportunity for export growth is tremendous.

But the potential benefits go beyond great financial returns for one industry or another. The real payoff may come in improving the quality of life. That, however, is tough to measure. University economist William D. Nordhaus developed a statistical gauge, which he calls "health income," as a way to calculate the economic payoff of medical care. He says society received up to \$2 of benefits for every \$1 it spent on health care in the 1980s—the last decade for which he has complete data.

Other economists have tried to measure the costs and benefits of treating specific illnesses. Cutler figures that great strides in treating low birthweight babies, for instance, have added years to their life expectancy, producing a benefit to the economy of \$200,000 per child. "I don't agree that health spending is a dead-weight loss," says Helen Darling, president of the Washington Business Group on Health, a consortium of large employers. "There have been distinct improvements in both health and productivity."

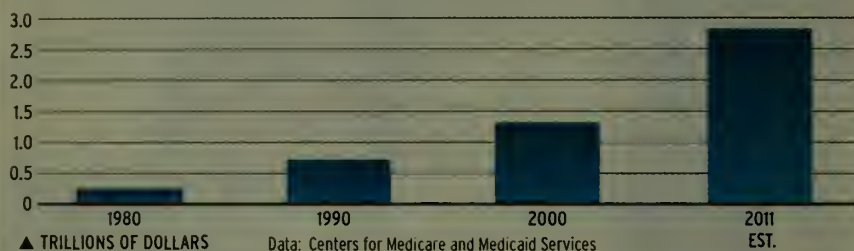
To test that theory, a few businesses are starting to ask tough questions about the return they can expect on health-care spending. Ford Motor Co., Wells Fargo, Bank One, Marriott International and others are trying to link the payoff from health care to its costs. "We want to understand what our return on investment is," says Steve Welborn, vice-president for corporate benefits at Wells Fargo & Co., which spends close to \$400 million annually to provide health benefits for its 130,000 employees.

Bank One Corp.'s medical director, Wayne Burton, has measured the costs in lost productivity of several common health problems, including migraines and allergies. He estimates that the nation spends \$1 billion a year treating migraines. But for corporations, the real cost comes from lost work days and reduced employee productivity. The price tag: a hefty billion annually.

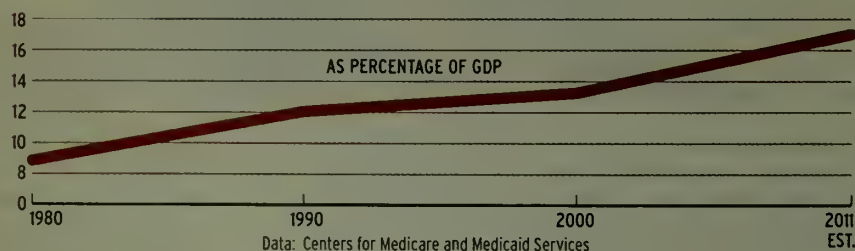
Giving migraine sufferers effective treatment would cost a fraction of that, although reliable estimates are hard to come by. But the key word is "effective," and—like other corporate purchases—not all health spending is created equal. A quick look at the wild overinvestment in telecommunications gear in 1999 and 2000 is powerful evidence of what happens when companies waste their dollars.

The risks are even greater when it comes

## Spending on Health Care is Skyrocketing...



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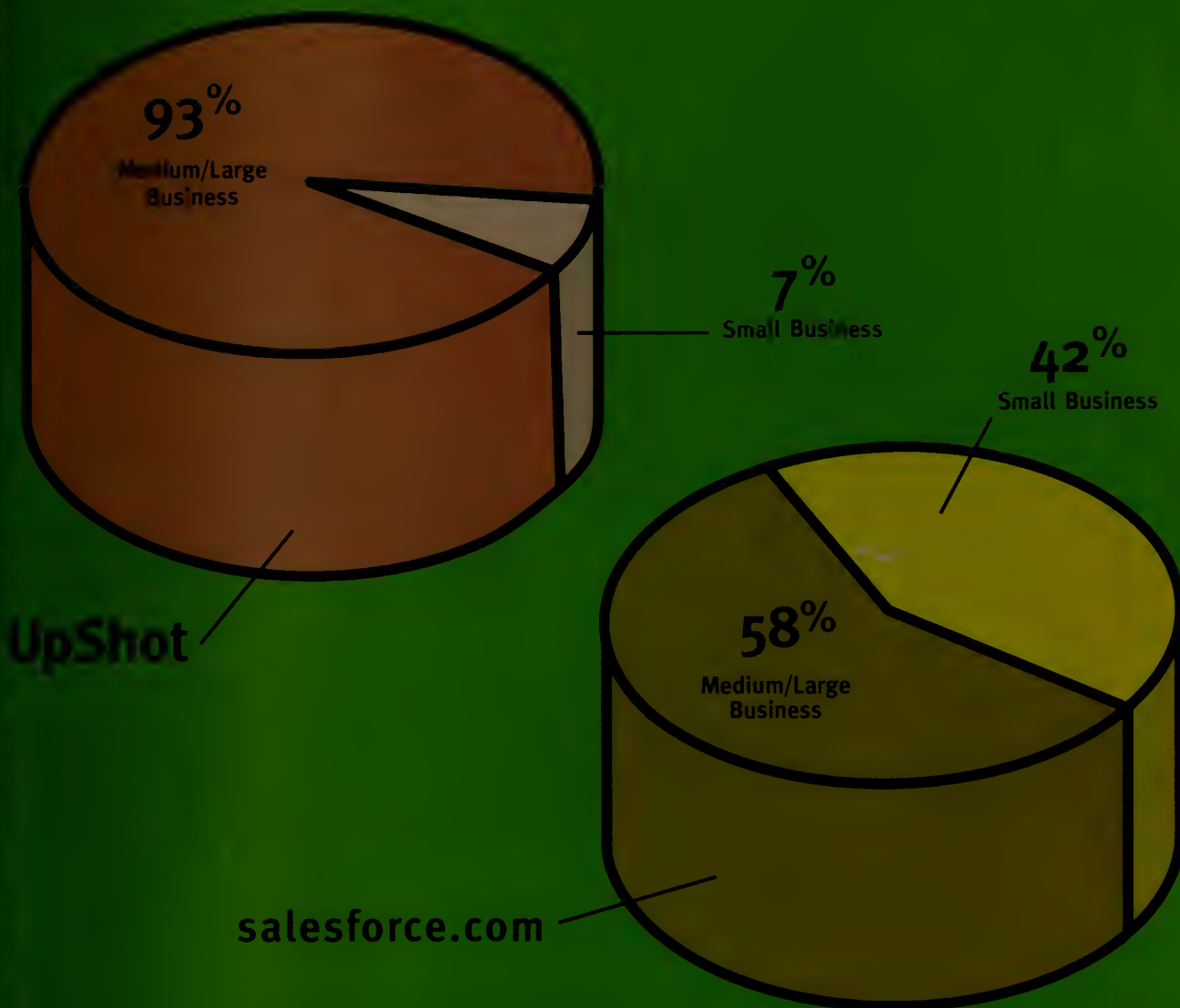
**HEART DISEASE** Heart-attack deaths have fallen by 20% over the past two decades, largely thanks to new treatments such as angioplasty. But because these therapies are more accessible, the total cost of all heart-attack treatment has increased by 60%.

**LOW-BIRTHWEIGHT BABIES** In the 1950s, most of these infants died. Because there was no treatment, the cost of care was low. Today, two-thirds of these babies survive, often without long-term complications. The cost of treatment: \$40,000 per baby.

**DEPRESSION** Until the mid-1980s, most depression was treated with therapy or drugs that had dangerous or unpleasant side-effects. The increasing use of more effective drugs changed the environment. From 1991-96 alone, the number of patients diagnosed and treated for depression increased fourfold. While the cost per treatment did not change, the overall expense exploded to \$10 billion.

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Customer Mix — Customer Relationship Management Magazine, May 2002 (Source: Summit Strategies).



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health care. And the price is in more than dollars. Nobody ever died from buying the wrong fiber-optic cable, but hospital errors kill as many as 100,000 people every year, according to the National Academy of Sciences Institute of Medicine.

Perhaps one-third of all medical spending—some \$600 billion—may be for unnecessary, out-of-date, or even dangerous treatments. A powerful example: surgery for arthritic knees. The procedure was thought to be a simple and highly effective method for treating achy knees, and the nation spent \$3 billion a year to do it. Now, a report by Houston Veterans Affairs Medical Center says the treatment is essentially worthless. “The performance we get for what we currently invest in health care is probably the biggest business failure in American history,” says Kevin B. “Kip” Piper, director of the National Health Care Purchasing Institute. “I can’t imagine this [happening] in any other industry.”

One reason for the problem: It takes years to determine the long-term impact of a particular course of treatment. But there is another, more manageable issue: The financial incentives for quality health care are totally skewed. Doctors and hospitals are paid for the volume of business they do, not the results of their care. Health experts say that changing those incentives will be critical to boosting the payoff from health-care spending. “If we spend more efficiently,” says Cutler, “we can be both richer and have a better quality of life.”

As a result, many American companies are

As the population grays, those issues—as spiraling costs—will come into sharper focus. Age-related illnesses, such as heart disease, strokes, arthritis, and back problems already account for 20% of U.S. health spending. That portion will rise as 65 million baby boomers

The other big driver of rising health-care

is technology. Medical advances make treatment cheaper, less painful, and more successful. As a result, the unit cost of care drops, but the number

of people getting treatment explodes—and so does the overall price.

Consider advanced heart attack treatment: Bypass surgery, which doctors cut into a patient’s chest and place blocked arteries. It was the treatment of choice in the ’80s, but the procedure was complicated, relatively rare, and expensive: \$4 million in today’s dollars.

Today, heart attack victims are most likely to be treated with angioplasty (unclogging the arteries with a balloon catheter and

sophisticated drugs and tiny mesh tubes to keep them from blocking again). It’s simpler, less painful, and, at about \$23,000, cheaper than a bypass.

These innovations are one reason why heart attack deaths have declined by 20% during the past decade. But they have also driven up the overall cost of cardiac care by nearly 50% since the mid-’80s. Among Medicare patients, largely because of greater use of angioplasty, costs skyrocketed over the period, from \$3 billion to nearly \$5 billion.

The real key to future cost savings and the efficient use of health dollars may come from some modest innovations on the detection and prevention front. Reducing high levels of obesity, cutting smoking, and early diagnosis and treatment of diabetes

“The performance we get for what we... invest in health care is probably the biggest business failure in American history”

looking at ways to put such incentives in place. One solution: pay higher fees to doctors who spend more time running critical diagnostics on patients with chronic illness, such as diabetes. The hope is that proper testing and early intervention will save billions in costs down the road.

But managing health costs is more complicated than simply determining the most cost-effective tests. Many dollars are spent on care for the elderly or those chronically ill and unable to work. Today, 3% of the population consumes 40% of health-care dollars, says Roberta Goodman, a health-care analyst at Merrill Lynch & Co. There are surely ethical reasons for funding such care, but it is harder to find economic benefits.

and high blood pressure would all have a dramatic impact on the costs of health care. “Big productivity gains come from the low stuff,” says Jon Gabel, vice-president of Health Research & Educational Trust in Washington, an arm of the American Hospital Association.

Such savings will be critical. The U.S. cannot afford to continue writing unlimited checks for health care. By spending wisely, the richest nation on earth can improve the quality of life for its people, helping them to live longer, more productive lives. But until it can distinguish efficient care from wasteful spending, it runs the risk of becoming both poorer and sicker. At \$3 trillion, the U.S. can do better than that.

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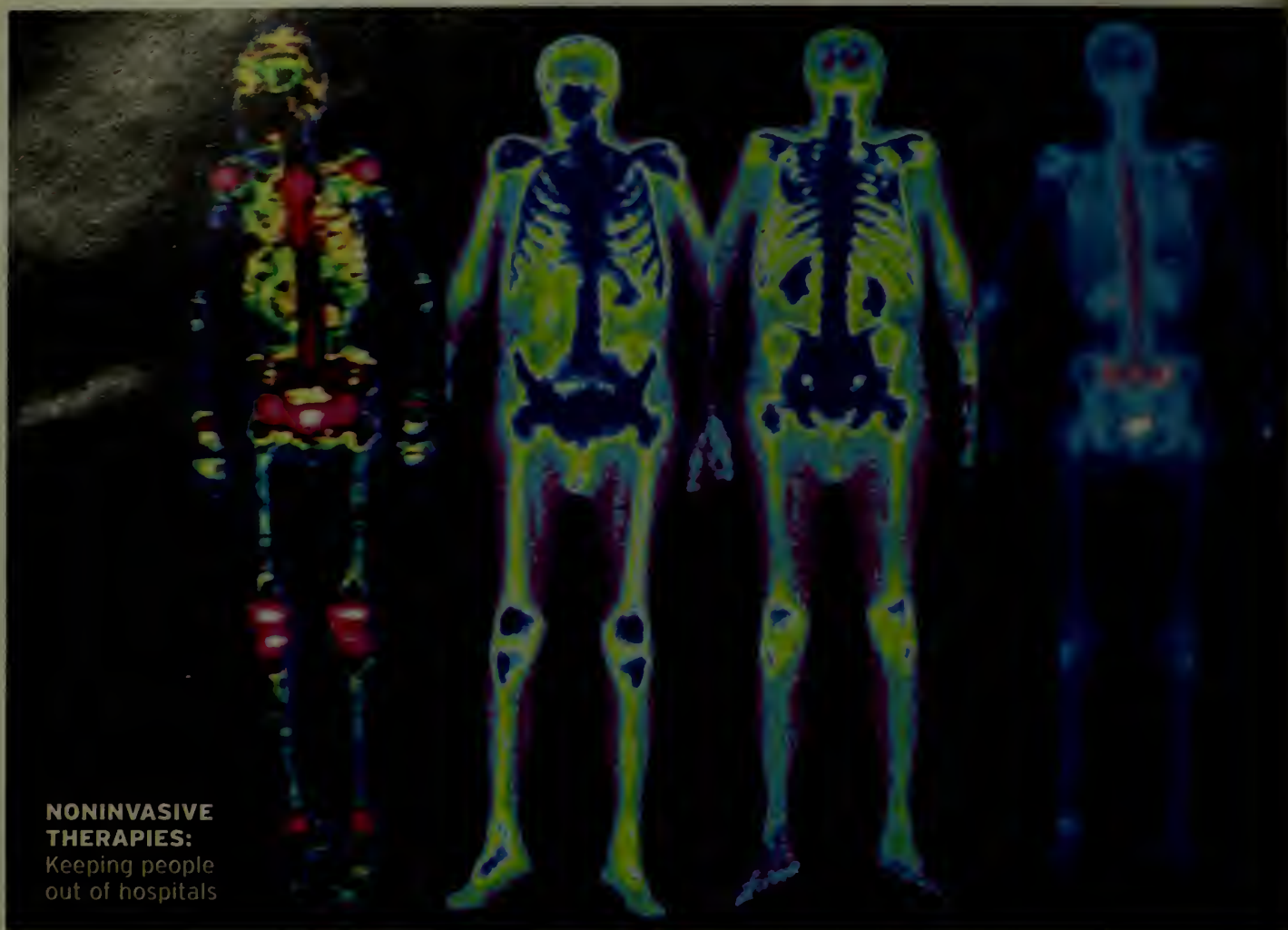
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# Minimal Medicine

HEALTH

21

New treatments aim to be less traumatic, shorter, cheaper, and more effective

# H

By Catherine Arnst

Here's one of your worst medical nightmares. On June 5, Dean Monahan, a 42-year-old steelworker in Reading, Pa., was scheduled for an angiogram, a common medical procedure used to determine if plaque is building up in a patient's arteries.

Monahan had experienced some pain in his chest and neck while exercising, which could indicate a blocked artery. He checked into Reading Hospital & Medical Center at 7 a.m., the angiogram was performed at 11 a.m., his arteries were declared completely clear, and he checked out at 4.

By 6:30 that night, Monahan had a temperature of 103. He rushed back to the hospital where the staff discovered that he had contracted pneumonia during his nine hours there. "I was out of work for a month and flat on my back for a good 10 days," says Monahan. "I now know how old people succumb to pneumonia—really saps all your strength."

What's particularly scary is that Monahan's story is not all that unusual. The Centers for Disease Control & Prevention calculate that 90,000 deaths in 2000 were caused by hospital infections, making the microbes that swarm medical centers the fourth-largest cause of death in the U.S. Then there are the medical errors committed in U.S. hospitals that kill anywhere from 44,000 to 98,000 people each year—more than die from highway accidents, breast cancer or AIDS. Consequently, one of the goals of development today is to eliminate, or at least minimize, hospital stays.

Thus the watchwords in forward-looking medicine

*He just used the proper Apache word for "hello."*

*Should we wash his mouth out with soap?*



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ical circles are "minimally invasive therapies." These are diagnostic and treatment strategies aimed at reducing the trauma, cost, and duration of medical care while, hopefully, increasing efficacy. The phrase encompasses a wide range of technologies, including high-definition imaging, robotics, miniaturized sensors, high-intensity sound waves, tissue engineering, and stem-cell manipulation. Some techniques are already indispensable in today's operating theaters; some are still years in the future.

There are, however, potential dangers in this rush to minimize medicine. "Just switching to a less invasive therapy isn't enough," warns Dr. David W. Rattner, a surgeon who oversees minimally invasive therapies at Massachusetts General Hospital in Boston. "You need to prove that it's more effective." Finding companies to commercialize these technologies is also a challenge, he says.

To that end, the Center for Minimally Inva-

er side effects than standard surgery, it is more easily tolerated. Dr. Timothy Wilson, rector of urologic oncology at City of Hope, predicts that this procedure will one day be formed on an outpatient basis.

The next generation of surgical tools not break the skin at all. At Brigham Women's, doctors are testing sound wave variation of the technology used to illuminate tumors in the womb—to blast fibroid tumors, precancerous breast lesions without making a single incision. A beam of high-intensity ultrasound is focused on a patient lying inside a magnetic resonance imaging (MRI) scanner. Soundwaves penetrate the skin to eradicate tumors. The hope is that the system, which was developed by an Israeli joint venture of GE Medical Systems and Elbit Medical Imaging called InSightec, will replace hysterectomies, mastectomies and might be used for brain tumors. "If you think about surgery, it's sort of medieval," says Dr. Darrell Smith, a Harvard University radiologist who led a clinical study of the InSightec system. "We're trying to get more elegant in the way we do this. It's kind of *Star Trek*."

Science fiction analogies are common in the minimally invasive field, where talk of nanotechnology and wireless sensors abounds. At a recent electronics symposium, University of Michigan professor Kensall D. Wise, a pioneer in the field of microelectromechanical systems (MEMS), described a future in which electronics implanted in the body could cure Parkinson's disease, deafness, and blindness. Wise described a microchip, now in clinical trials, that uses intelligent implants to detect an epileptic seizure and deliver electronic stimulus and drugs to patients. "They may not know that an attack is under way," he also predicted the development of intelligent stents that, when placed in an artery, would warn doctors if the vessel had reclogged without the need for an angiogram—the procedure that caused Monahan so much trouble.

Hospital operating rooms themselves should also become safer. Doctors at Mass General, led by Dr. Rattner, hope to do their first procedure within a month in an "operating room of the future"—a surgical theater full of computers, robotics, sensors, and sophisticated imaging equipment. Every person and object that enters the room will carry a radio-frequency ID tag. If a nurse approaches the patient with the wrong medicine, a scanner will sound an alert. It will also raise an alarm if doctors start preparing the wrong site on the body—a common mistake in hospitals. A patient will be operated on remotely using robotic arms inside an advanced MRI machine that updates the image every second or less, allowing surgeons to view their progress in real time on a video monitor. Computers will provide the exact coordinates of the tissue to be repaired.

Rattner predicts that it will be several years, at least, before such an operating room becomes commonplace. In the meantime, just hope you stay out of the hospital.

## Doing the Least Damage

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sive Surgical Therapies was established in Boston in 1993 to coordinate clinical and industrial research. Its members are researching techniques for the treatment of heart disease, stroke, cancer, and trauma. A typical effort: Dr. Edward P. Ingenito of Brigham & Women's Hospital in Boston is developing a nonsurgical method for removing damaged lung tissue in emphysema patients. His plan is to inject a biopolymer that will collapse and scar over the target area of the lung, thus reducing its volume.

Some minimalist therapies have already proven their worth. Laparoscopy, in which surgeons insert tiny cameras and long narrow instruments through incisions in the body, has been used since the late 1980s to repair knees and other joints, but the technique is slowly being applied to internal organs as well. City of Hope Cancer Center in Los Angeles has led the way in using laparoscopy for one of the most dreaded operations, removal of a cancerous prostate gland. Surgeons make five small holes rather than the standard six-inch incision, cutting blood loss by 50% and greatly reducing recovery time and hospital stays. Although studies have not confirmed whether the operation causes few-

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PRESENTS

# COMDEX

FALL 2002

THE GLOBAL TECHNOLOGY MARKETPLACE



# The Take-Charge Patient

**T**

By Carol Marie Cropper

he willingness to question a physician has always been a key survival skill for patients. But with new drugs and medical procedures flooding onto the market at an unprecedented pace, patients are confronting more choices about treatment than ever before. Many are now insisting on something more than a few minutes of dialogue. They want to weigh therapeutic options with their physicians and share in the decision-making—to be partners in, not simply recipients of, their medical care.

In the U.S., many people are already primed to do their own medical homework. After years of wrestling with managed care, they've become skeptical health-care consumers. They're also more aware of their role as buyers, thanks to constant marketing assaults by drug companies, hospitals, and health plans—and new employee-benefits initiatives that threaten to shift more costs to employees.

Awareness, however, is not enough. Patients must really take charge of their own care, and the Internet provides the tools to do so. In a matter of hours, anyone can research a wide range of medical matters, from symptoms and pathology right up through clinical trial enrollment. And even doctors acknowledge that research can pay off. "A more informed patient makes a better patient and has a better outcome," says Dr. J. Edward Hill, chairman of the American Medical Assn.'s board of trustees. Such patients tend to take better care of themselves and more quickly understand what their doctor tells them, he says. "Knowledgeable patients keep us on our toes."

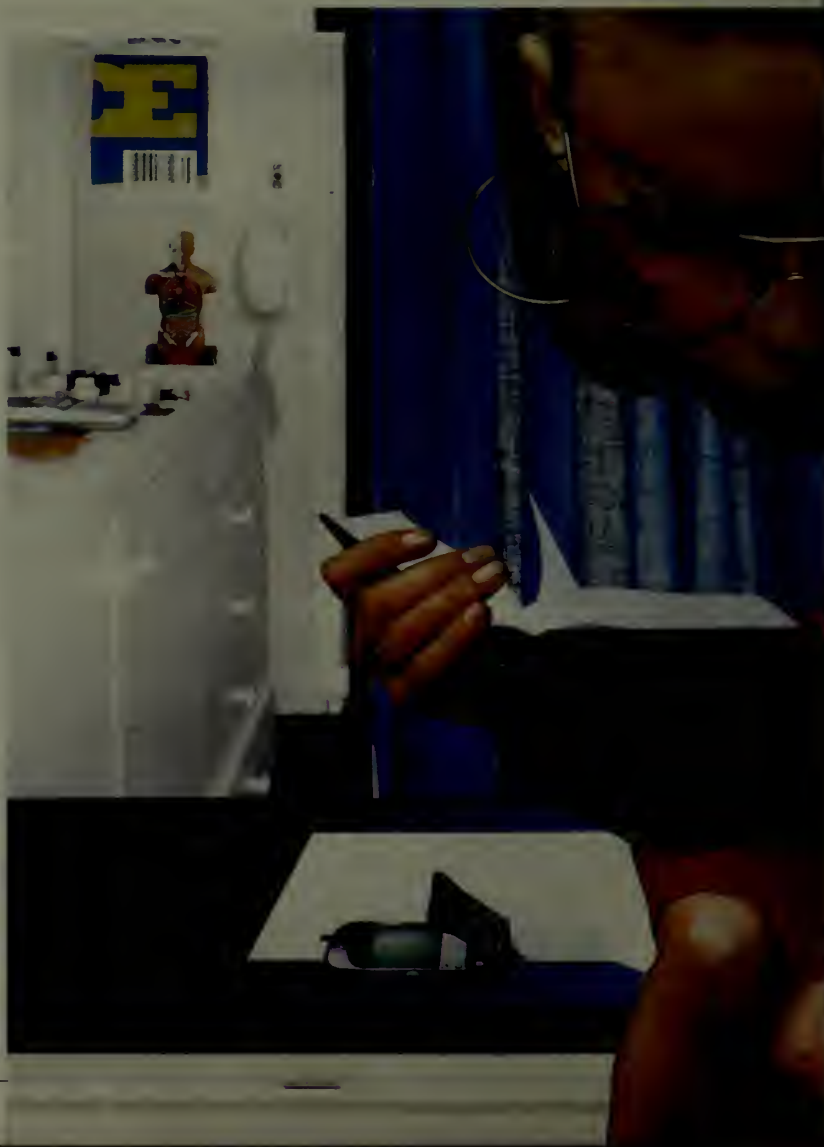
Dr. Albert G. Mulley Jr., chief of general medicine at Massachusetts General Hospital, notes another reason patients should take an active role. "More than doctors or patients generally appreciate," he explains, "many medical decisions have more to do with personal preferences than they do with medical probabilities." Surgery to treat a man for benign prostatic hyperplasia—an enlarged prostate—will probably relieve his need to make late-night trips to the bathroom, but might leave him incontinent or with a sexual

## HEALTH

Now, you and  
your physician  
can be partners.  
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for everyone

dysfunction. Only the patient can decide if a problem is annoying enough to make him or her take that risk, says Mulley. Similarly, clinical trials show that women with early-stage breast cancer are just as apt to survive with a lumpectomy and radiation therapy as with a mastectomy. One woman might fear six weeks of radiation treatments and a possible recurrence in the same breast. Another might want to save money on breast at all costs.

Heart patients confront equally perplexing trade-offs. A patient facing double-bypass surgery might have to weigh the prospect of relief from angina pain against the possibility of cognitive loss and an increased risk of dying soon after surgery. Whether they opt for the knife or rely on beta-blockers and aspirin may depend on how bearable the pain is—something only the patient can know.



many cases, doctors don't agree on what's That much is clear from the *Dartmouth At-Health Care*, a Dartmouth Medical School t that tracks how doctors treat patients in ent parts of the country. Examining 10 of Medicare data, the researchers con- l that the type of treatment patients re- often depends on their location. Folks in Ore., for example, are four times more to have surgery for lower back pain than in Honolulu, says Megan McAndrew Coop- itor of the *Atlas*. The rate for spinal fu- a procedure in which the vertebrae are to relieve chronic back pain—is almost 10 higher in Provo, Utah, than in Worcester. The latter example is especially troubling se there may be far less drastic alterna- Surgeons can go in and clean away bone and ruptured disk fragments to ease the ure on pinched nerves. "We joke that which ou turn off the causeway determines what of treatment you get," says Cooper. e problem isn't simply that some regions ore backward than others. Consumers' kbook, an organization that evaluates doc- and hospitals, cites a study that highlights neven distribution of medical knowledge. years after the National Institutes of h concluded that a type of bacteria called *obacter pylori* causes the majority of peptic as—not stress and stomach acid, as many rs previously believed—large numbers of

~  
The care  
you get  
may vary  
depending  
on the type  
of doctor—  
and where  
the doctor  
practices

Michigan physicians still were not prescribing antibiotics to treat the cause of the ailment.

In some cases, the treatment depends less on geography, and more on the type of doctor consulted. Clinical trials suggest that a man with early-stage prostate cancer lives just as long whether he has his prostate removed or not, says Dr. John E. Wennberg, a Dartmouth researcher. But when a man under 75 years of age consults a urologist who performs such surgeries, a likely recommendation is radical prostatectomy. A radiation oncologist might favor (no surprise) radiation therapy. Even when doctors agree on an answer, it can change from one day to the next—witness the about-faces on hormone replacement therapy and on knee surgery to treat arthritis.

Patients who do their own homework often turn up information their doctors may have overlooked, according to Steven Schneider, a family doctor and chief medical officer of Healthwise Inc., which provides medical information on the Internet. Schneider describes his own comeup- pance at the hands of a patient with atrial fib- rillation, a quivering of a heart chamber. Schnei- der had prescribed Coumadin, a blood thinner that requires monthly monitoring. Then the pa- tient produced a study showing that aspirin was a reasonable alternative for low-risk patients. Schneider switched the man to the cheaper, less dangerous drug, and "he did just great."

Chalk one up for the patient. ■

## Doing Your Homework

*In the growing ocean of medical information, some sources are better than others. Here are a few you can trust:*

**NLM.NIH.GOV** The National Library of Medicine's Web site features MEDLINE and MEDLINEplus. Entries range from technical articles to general health info.

**NATIONALHEALTHCOUNCIL.ORG** Disease info, and links to member societies and foundations, such as the American Cancer Society and the American Heart Assn.

**MAYOCLINIC.ORG/HEALTHINFO/** Medical information from the famed Rochester (Minn.) clinic.

**ONCOLINK.COM** A user-friendly info site, from the University of Pennsylvania Cancer Center.

**GUIDELINE.GOV** Sophisticated information on treatment guide- lines from the National Guideline Clearinghouse, a project of the U.S. Agency for Health-care Research & Quality.

**HEALTHWISE HANDBOOK, A SELF-CARE GUIDE FOR YOU** Home reference, with advice for treating common medical problems.

**MAYO CLINIC FAMILY HEALTH BOOK** Comprehensive medical reference from the Mayo Clinic.

**FOUNDATION FOR INFORMED MEDICAL DECISION MAKING** Videotapes examining patient options for prostate and breast cancer, lower-back pain, and other common ailments.

Data: *BusinessWeek*



# Don't Kill All the Trial Lawyers

# H

By Mike France

ow bad are things right now? So bad that plaintiffs' lawyers are starting to look good.

At a time when regulators are a step behind public anger and self-policing is a joke, the attorneys who make a living suing Corporate America have become one of the most powerful forces compelling executives to behave. The scandals have given them a unique chance to pose as Robin Hoods. Consider stock fraud litigator Bill Lerach—who was so widely demonized in the '90s that he all but stopped talking to the media. Lately he has been defending Enron shareholders, airing his own agenda for cleaning up executive suites, and has even been dubbed America's "top corporate crime fighter" by the left-leaning *The Nation* magazine.

Can plaintiffs' lawyers really stand in for spineless politicians and weak Securities & Exchange Commission chairmen? Yes and no. Numbering about 150,000 strong nationwide, the plaintiffs' bar constitutes a de facto army of private attorneys general charged with enforcing our securities, product safety, and workplace laws. "I'm a middle-of-the-road Republican," says Henry T.C. Hu, a corporate and securities law professor at the University of Texas at Austin. "And I have no doubt that if we didn't have the private securities bar, executives would lie more often."

At the same time, there's no way Lerach can ever sub for SEC Chairman Harvey L. Pitt or the head of a consumer protection agency. Plaintiffs' lawyers simply don't have the training, legal authority, or financial incentive to be true corporate cops. They're private businessmen. That means they're good at doing things that earn them money, such as winning big awards for victims,

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and bad at things that don't, such as dev regulations and compliance programs to er that corporate wrongdoing isn't repeated.

Consider the fight against Big Tobacco—epic battle usually at the top of the Association of Trial Lawyers of America's greatest-hits list. A coalition of tort attorneys, working for state attorneys general on a contingency-fee basis, on a powerful industry that had defanged the White House, Congress, and the Food & Drug Administration. They managed to win a \$36 billion settlement that forced Philip Morris Cos. and other tobacco companies to change the way they marketed and distributed their product, v pocketing over \$10 billion themselves.

Under the deal, tobacco companies are now handing out about \$10 billion annually to the states. That has driven the price of cigarettes up by more than \$1 a pack and driven down teen smoking by an estimated 8%—a public health victory.

But nearly every other feature of the deal has disappointed. Money that was expected to go to antismoking programs has been diverted into general funds. Billboards are gone, but manufacturers have compensated with new ways to promote their brands. "It was a good first step, but I think we could have done much better," says Richard I. Lerner, chairman of the Tobacco Products Liability Project in Boston.

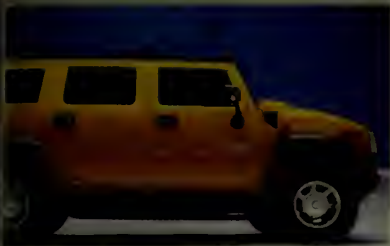
Products Liability Project in Boston

Look for the same mixed results in the corporate attack on companies caught in the scandals. Plaintiffs' attorneys will be aggressive about pursuing anyone proven to have cooked the books at Enron Corp., WorldCom Inc., and elsewhere. They probably won't be helping small investors who took Merrill Lynch & Co.'s questionable advice to put money into the firm's investment banking clients. Why? Because many of the investors lost less than \$100,000, not enough for an attorney working for a one-third take. And any nonmonetary penalties that plaintiffs' lawyers insist upon are likely to be window-dressing.

So tort lawyers are a mixed blessing. They can seem like parasites when regulators are doing their job. But when government stops moving the store, they don't look half bad.



**When regulators fall short, it's up to plaintiffs' attorneys to put the hurt on corporate miscreants**



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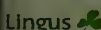
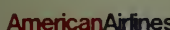
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Your guide to our advertisers' upcoming events, products, and services.



# Didja C That Kewl Ad?

# T

By Gerry Khermouch

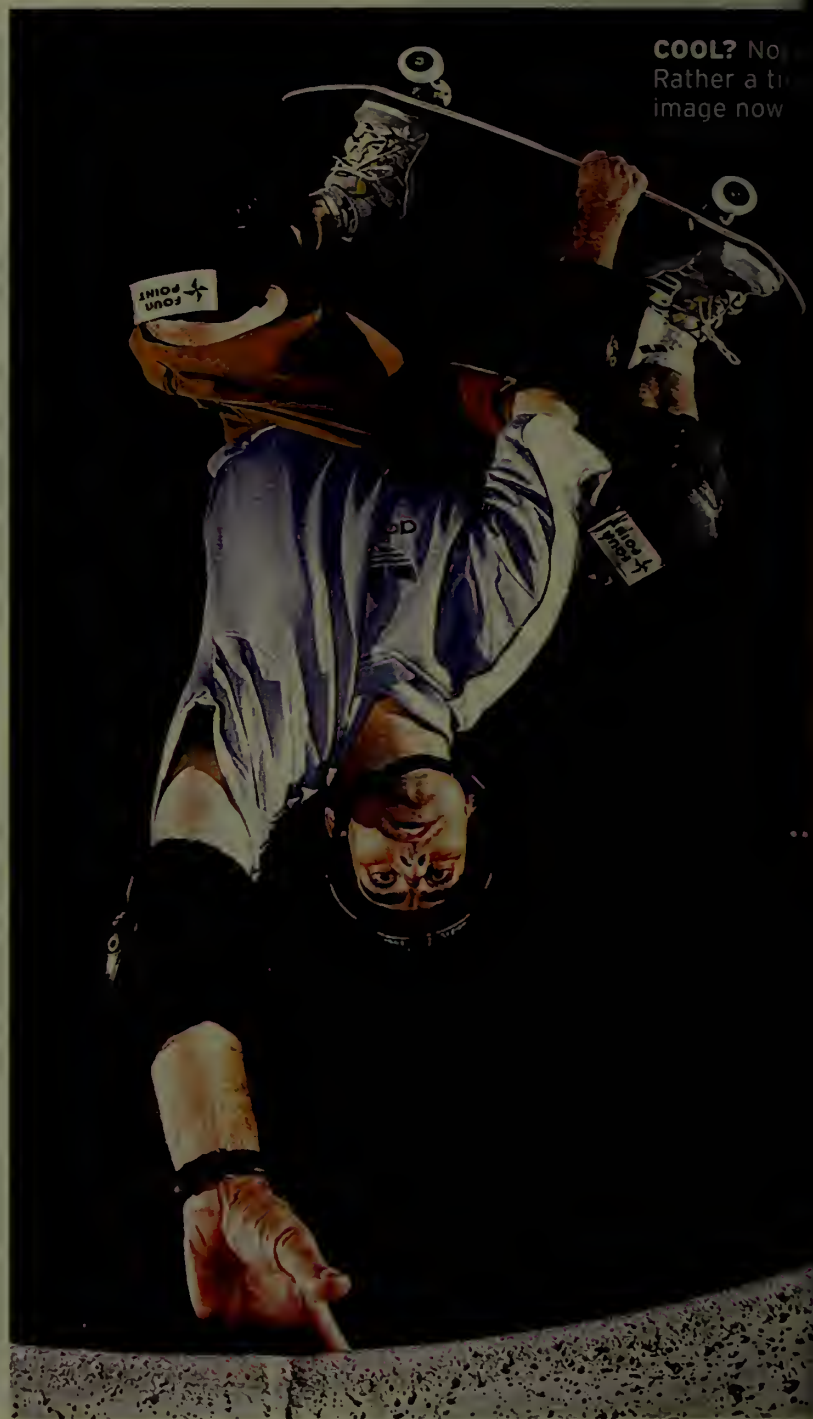
here's a midlife crisis brewing in marketing. Rules honed over decades that are supposed to make everything from cereals to credit cards irresistible to skeptical baby boomers have turned out to be a major turnoff for the newest generation of big spenders: the 50 million 13- to 23-year-olds who shell out \$150 billion a year in the marketplace and are forming brand preferences that could endure for decades.

As a result, these new consumers are turning the marketing canon on its head. Take their attitude towards ads. While boomers mistrust advertising, their kids love it—if it's witty and not condescending. To them, ads can be an alternative form of entertainment. But hitting the right note is hard. Ads aimed at this group can't be too obvious, but they do have to be honest about their intent.

So what are the rules of engagement when it comes to young consumers? To find out, *BusinessWeek* polled successful marketers and then ran the rules past five 18-year-olds—Sarah Copernine, Dana Cyboski, James King, Thom Carvette, and Max Ugwoth—convened by youth-marketing specialist North Castle Partners, in Stamford, Conn. Here's what we found:

## Rule 1: Don't talk down.

Forget the authoritative "experts" who swayed their parents; this group won't believe a word they say. Younger consumers want to feel they are drawing their own conclusions about products, brands, social issues. Many antismoking and anti-drug-abuse efforts get a thumbs-down from kids for browbeating the audience. "If you're con-



## SOCIETY

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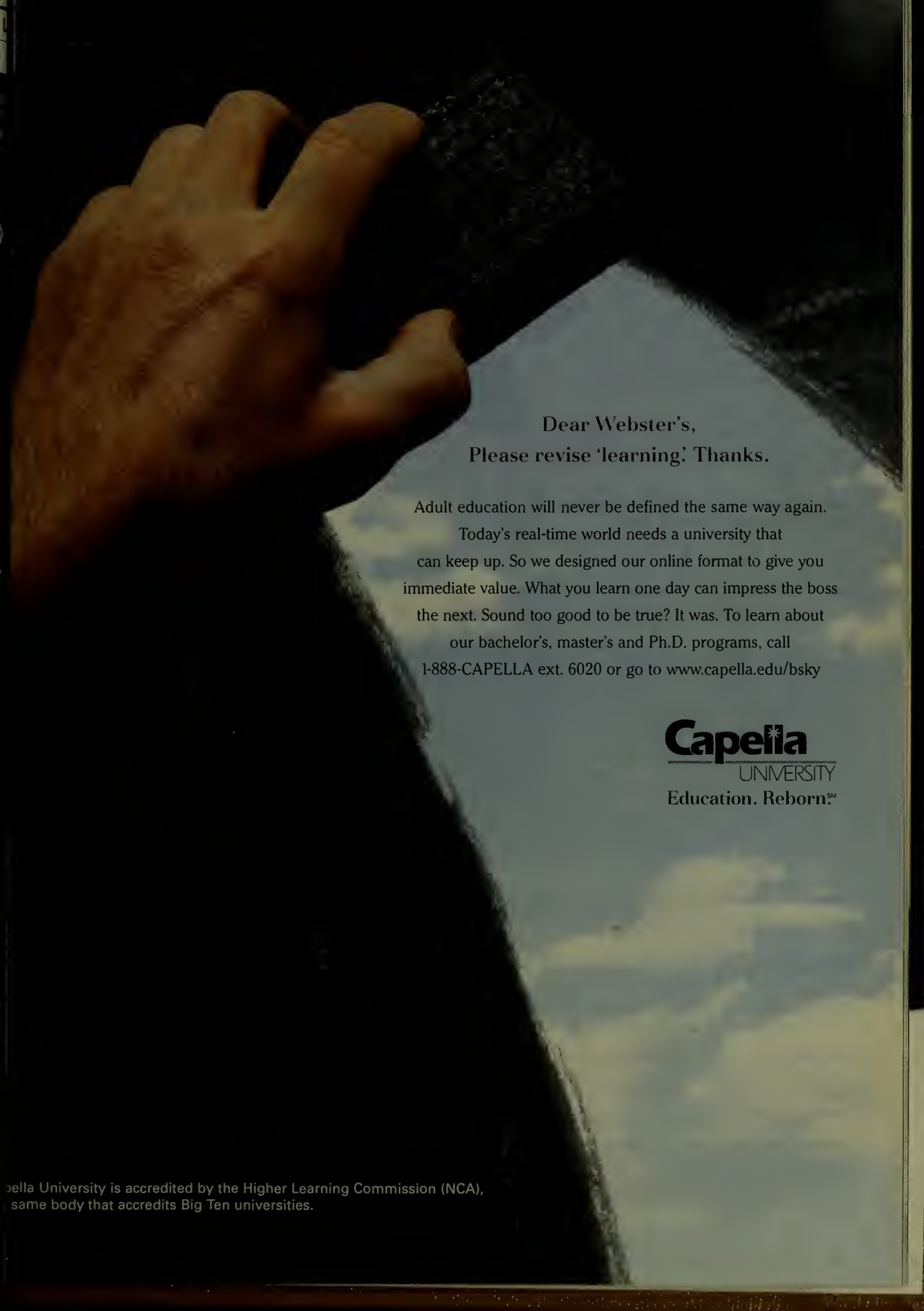
What bewildered advertising executives need to know to pitch a wary generation

sciously trying to make youth do something they're going to sniff that out," warns C. Strain, vice-president of marketing at sneaker maker Vans Inc., which operates skate parks, sponsors the Warped rock tour, and generally "hangs" with its customers, so that the brand's image can seep out on its own. "You've got to develop their long-term trust," Strain says.

*I don't like it when someone tells me what to do. Those drug and sex commercials prey on my fears. What do they know? Also, I don't like it when they show a big party and say come on and join in with this product. That's not how it works.*

**Rule 2: Don't try to be what you're not. Stay true to your brand DNA.**

"Teenagers have a built-in BS meter,"



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Michael Wood, vice-president at Teenage Research Unlimited in Northbrook, Ill. "Too many people try to be cool in ways they have no business being cool in." These days, when even Ma Bell is using skateboarders in ads, it's time to find a unique image that's true to your product.

Since kids put a premium on straight talk, it helps to show utter confidence and accountability. Procter & Gamble Co. backs up a money-back guarantee on its Old Spice High Endurance deodorant with an invitation to phone 1-800-PROVEIT. Chocolate drink maker Yoo-hoo Beverage Co. showed it's not afraid to make fun of itself by sending a garbage truck painted in the brand's signature yellow-and-blue to hand out samples.

*When you say "I'm a teen"—you're not. Like, extreme sports are fine, but after a while you start to get tired of it in advertising.*

**Rule 3: Entertain 'em. Make it interactive, if you can. And keep the sell short.**

Boomers may resent mingling ads with the surrounding "content," but the Internet generation likes finding brands in unexpected places. New York-based DVC Brand Games weaves them into free electronic games for clients like Bic, McDonald's, and General Mills. "The seamless integration of the brand message is not only accepted but cool," says DVC Executive Vice-President Jim Wexler. Jones Soda Co. invites consumers to send in artsy photos for use on the labels, while the California Milk Processor Board allows youngsters to create their own TV ads.

## Alien Thoughts

*Today's teens don't think like their parents. Here are some of the differences that marketers need to know:*

**BOOMERS** You had better entertain them because they regard TV ads as an annoying intrusion.

**KIDS** You had better entertain them because the prospect of catching appealing ads is part of the reason they're watching that TV show in the first place.

**BOOMERS** Regale them with facts from experts as a way of overcoming their deep skepticism of advertising.

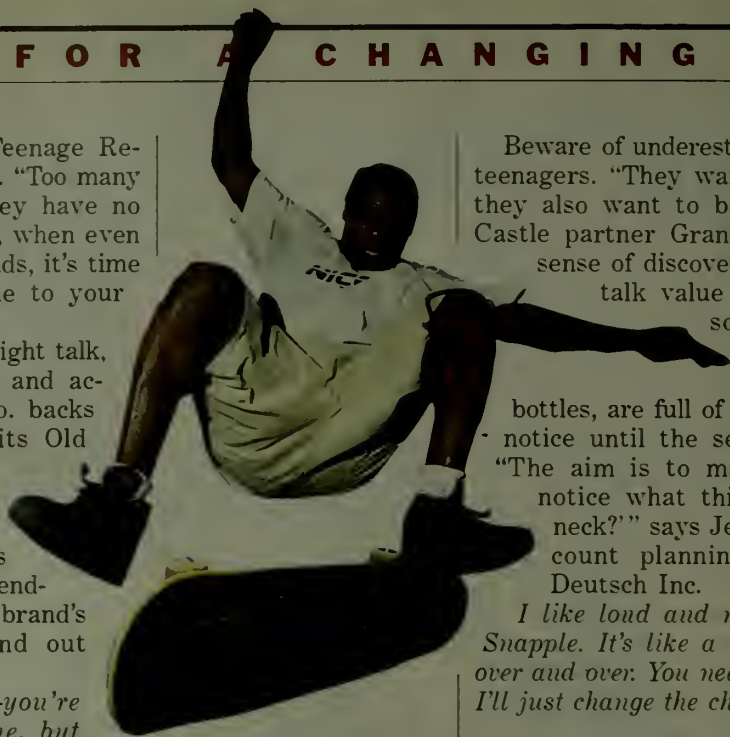
**KIDS** Keep the brand message quick and simple. If they want to learn more, they'll check out your Web site.

**BOOMERS** Wow them with new media. It makes them feel that they're still cutting-edge.

**KIDS** They've grown up with this stuff. They're blasé. Keep it functional.

**BOOMERS** Even after September 11, irony still works. Show bourgeois boomers you share their subversive worldview.

**KIDS** Sure, they get irony, but keep it upbeat. Don't ridicule others. And don't employ stereotypes because teens think diversity is what it's all about.



Beware of underestimating the intelligent teenagers. "They want to be entertained; they also want to be intrigued," says North Castle partner Grant MacDonald. Build a sense of discovery into your ad generation.

talk value among peers—important social currency. Snapple's latest ads, featuring animated bever-  
bottles, are full of details that viewers notice until the second or tenth go-round. "The aim is to make them say: 'Did you notice what this bottle had around its neck?'" says Jeffrey Wolf, director of account planning at Snapple's agency, Deutsch Inc.

*I like loud and not boring.... Make it Snapple. It's like a movie you want to watch over and over. You need that in a commercial. I'll just change the channel.*

**Rule 4: Show that you know what they're going through, but keep it light.**

It has never been easy to be a teenager that hasn't changed. So show them that you understand. For a commercial for Herbol Foods Corp.'s Ice Breakers, North Castle used the brand's minty product benefit to a stressed-at-approaching-a-strange-girl-at-a-party. "I'm wearing my lucky boxers," he reassured himself. "Don't trip. Don't drool. Relax. Breathe my breath?"

"Blatant honesty" shows you're in sync with their concerns, says Ellis Verdi, whose agency DeVito/Verdi, has created ads for online text vendor eCampus.com. "Buy all the books you never open from the store that never closes. It horts one."

*Being a teen is tough, but don't use it to mind me of the bad stuff. Keep it upbeat.*

**Rule 5: Customization and interactivity are good. But don't kid yourself into thinking that new media equals cutting edge; spamming won't work.**

This is a generation that revels in self-expression, and the most successful marketers give them plenty of opportunity. Nokia Corp. offers add-ons like nameplates and download ringer tones. Nike Inc.'s Air Presto sneaker can be ordered online in special prints, combinations, and a personalized ID tag. New medium or not, spam is not interactive and gets the thumbs-down.

*It's fun to make your own stuff. I customized my Presto to be really cool.... No one likes e-mail ads or reads them. It's crap. It's not about interacting and it's not new.... Like, older people think AOL is cool. They don't get it.*

**Rule 6: Not that they'll really let you, but if you do know those savvy, plastic-wielding teens, you don't, no list of rules will help you get their attention.**

*They should have had us make the list. They should have first asked us.*

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*This is part of the Heidrick & Struggles' Leadership Capital series on the topics of governance and leadership. Subsequent articles will focus on the specific skills and challenges for senior-level management roles and on the critical issues facing corporate leaders today.*



FOCUS ON:

# BUILDING BETTER BOARDS



John T. Gardner

*Vice Chairman, Board Services*

Heidrick & Struggles

**T**he job of the corporate chief executive officer has never been trouble-free, but rarely have business leaders faced such a pressing set of issues as they do today. They must constantly seek new ways to differentiate their organizations from the mass of companies, in a marketplace so crowded and precarious that the phrase "sustainable competitive advantage" begins to sound like a contradiction in terms.

Adding to this already formidable challenge, the recent, well-publicized cases of corporate fraud and accounting improprieties have touched off a widespread crisis of confidence in business. Extreme misconduct at a handful of unethical organizations has placed every corporation under intense scrutiny. In particular, boards of directors are being examined as never before for their independence, integrity, and effectiveness.

In such a highly charged atmosphere, it is difficult, but absolutely crucial, for corporate leaders to recognize that these very challenges create the opportunity to forge a lasting competitive advantage. The marketplace will reward corporations that meet the demand for integrity—corporations whose leaders have the imagination to envision their boards of directors as a unique strategic asset to both management and shareholders. These leaders will move themselves and their organizations ahead of the pack by being among the first to recognize that *exceptional governance makes companies better*.

Unlike the complacent, unquestioning boards now in the limelight, a successful board governs its company by continually challenging every significant facet of its operations: its business model, strategies and underlying assumptions; its operating performance; and its leadership development. Far from being management's rubber stamp, the best-in-class board fosters a culture of rigorous, relentless examination. It

presses for continual improvement, setting a tone for senior management that reverberates throughout the organization—to employees, customers, shareholders, and the communities served by the company. There is no better way to achieve sustainable competitive advantage.

A best-in-class board is much more than a roster of prominent names. Truly exemplary boards are well-balanced teams that harness the diverse experiences, skills, and intellects of their directors to pursue the strategic objectives of the companies they serve. The members of these boards possess a rare talent to see the big, broad picture even as they know when to drill down on specifics. They have the fortitude to speak openly and candidly, and the humility to remember that they're not in charge of the company's day-to-day business. Above all, says Richard Cavanagh, CEO of the Conference Board, good directors display a competency that is "not so much a skill as a mindset. It's a quality of mind that questions rather than accepts, coupled with the courage to ask difficult questions in a constructive way. And that, I think, is the toughest quality to find."

**Objectivity. Values. Acumen. Judgment. Capacity. Zeal.** These are some of the core traits we look for in board candidates. These traits are necessary whether our client company is addressing a leadership crisis, a financial squeeze, or an adverse economy; whether it is experiencing rapid growth or wrenching change. But as we assess board candidates, we also look for those with wisdom and experience relevant to the unique circumstances of the client company. These candidates need more than intelligence or charisma—indeed, even candidates with distinguished records can contribute little to the future of an enterprise if they are closed off to new ideas and approaches, or oriented toward past achievements rather than challenges yet to come.

The best directors enrich their world with the perspective of someone who has faced some of the same problems the company will face in the future. In addition, organizations in the early stages of building—or rebuilding—a boardroom culture are often best served by a knowledgeable, forceful advocate for exemplary corporate governance. The social dimension must not be ignored, either. Effective directors, knowing that a truly strong personality doesn't need to be overpowering, are able to work well in a group. Of course, directors must be independent in more than name only. Inevitably, those whose achievements qualify them as board candidates will follow paths, but shareholders will have the patience for directors whose principal qualification is close friendship with the CEO or other board members. Members of a well-balanced board are appropriately sociable but unconstrained by the ties of friendship when it comes to speaking their minds clearly and candidly.

The stock market's recent declines are a stark reminder that investor confidence relies on corporate integrity. In the book *Leaders Talk Leadership*, compiled in September 2002 from Oxford University Press, London Business School's resident leadership expert Jay R. Singer writes that best-in-class companies have integrity built into their boards and their books. I would add that integrity is built into their *boards*, too.

#### THE SHAREHOLDER'S RESPONSIBILITY

As shareholders, we all have a role to play in ensuring board integrity. After all, we have a vested interest in boards of directors and their governance style and practices. We can no longer afford to be indifferent—our failure to do our homework has already cost us too much. Examine the boards of companies you invest in—the individual members as well as their collective contributions. What sort of experience do the directors have? At what stage are they in their professional careers? What relationships, apart from their board memberships, do they have with the company? If a director is a former or current CEO, look at the performance of that director's company and the attitudes of its customers and employees. Who is on that company's board, and

what is its reputation? These sorts of questions can help us, as shareholders, differentiate the companies that are worthy of our trust and capital from those that are not.

#### INSTITUTIONALIZING BOARD REVIEWS

One potentially strong vehicle for evaluating boards is a formal board review process. At present, only about 40 percent of North American companies conduct such reviews, and even fewer review individual board members. Further, companies that do conduct reviews often do so only as a prelude to removing a particular board member.

*A best-in-class board is much more than a roster of prominent names. Truly exemplary boards are well-balanced teams that harness the diverse experiences, skills, and intellects of their directors to pursue the strategic objectives of the companies they serve.*

But that's selling the process short, says Roger Raber, CEO of the National Association of Corporate Directors. "If you have a problem on the board, you can just deal with it. But if your board buys into the review process—and if it's committed to acting on its findings—good things can come of it, like better meetings and more engaged directors."

Heidrick & Struggles already has an active board review business in Europe, and it is rapidly expanding to the Americas as more and more corporations adopt the practice. Our clients find that a disciplined, rigorous professional assessment and review of a board makes it possible to identify

areas where improvement is needed and to pinpoint potential problems while they're still in their early stages. The review process also helps in formulating a governance strategy that complements a corporation's business strategy—and it helps ensure adherence to both.

The first milestone in any board review is an overall evaluation of the board and possibly of its most important committees, particularly the governance, audit and nominating committees. Formal evaluations of individual directors follow close behind. We believe that widespread adoption of these review processes is on the horizon. But even in the absence of a formal review, we believe that boards need to be bolder in recognizing when a member needs to step down. Sheer incompetence should not be the sole grounds for removal. There are many capable, committed directors whose talents and experience simply no longer meet the needs of the company they serve. Their removal is no disgrace—it merely constitutes an acknowledgement that times change.

Companies evolve, and so should the boards that guide them. Without an infusion of new perspectives and skills, boards can become stale and insular. The challenges are knowing when a member's abilities are no longer relevant or of high value, and then replacing that member with new talent. This is never easy, nor should it be, but formal, periodic board reviews will both facilitate the process and make it more productive. A dynamic, engaged board is one step toward a competitive advantage that is virtually impossible for rivals to duplicate. A formal review is a powerful tool for making such a board a reality.

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# The Importance of Teaching Tots



# E

By Alexandra Starr

quality of opportunity. It's that long-cherished American ideal that citizens can shape their destinies regardless of the circumstances they are born into. Since at least the early 1800s, the U.S. has seen education as the ticket to success, especially for poor and working-class children. What's more, for leaders such as Thomas Jefferson, it was canon that no democracy could function properly without a literate populace. Out of this tradition grew the movement for compulsory public schooling from kindergarten to age 18.

Now, after years of research on the topic, it turns out that starting an education even at age 5 or 6 is too late. Children form basic cognitive abilities in their earliest years, and those who don't get exposed to letters, numbers, and social skills at home quickly lag behind those who do. Poor children typically enter school a full year and a half behind their middle-class peers in language ability, studies show. So millions of kids start their lives with an educational deficit.

That's why we have to get 'em while they're still tots. Short of wiping out poverty altogether,

er, the U.S. should offer preschool education to the children of the poor—and maybe even all children. Providing disadvantaged kids with a chance to learn numbers and letters would make a lifelong difference. They would do better in school and as adults, when they would likely become productive workers. “Children learn more in their early years than they

**RIVERDALE, N.Y.:** Some 200 children attend Susan Wagner Day School

will again,” says Alison Nik, professor of psychology at the University of California at Berkeley. “With the dissolution of the extended family, the best way to support early learning is

publicly funded pre-K.”

The benefits to society make the hefty tag well worth it. Providing preschool for low-income children would run about \$25 a year. But this would be more than offset by lower arrests, higher tax revenue, and a better-prepared workforce. In fact, top-notch programs have provided a payback of nearly \$8 for every \$1 invested in poor children's early education, according to studies of pre-K attendance into early adulthood (table, page 166). Those figures have caught the attention of politicians on both parties. Some Republicans like the Democrats do, too, including Vice-President Gore, who in 2000 proposed spending \$50 a year to offer preschool to every 3- and 4-year-old. Although his idea went nowhere, it's fast becoming more accepted that prekindergarten at least for children from low-income families is a prerequisite for a fair society.

Studies show that pre-K benefits children at all income levels, but poor kids clearly reap the most. A University of Kansas study in the 1980s reached the breathtaking conclusion that 3-year-olds with professional parents use more advanced vocabularies than mothers on welfare say nothing of the 3-year-olds of those mothers. “These children lack the kind of environment we just presume most kids will be exposed to,” says Isabel V. Sawhill, a senior fellow at the Brookings Institution.

Early intervention, though, can produce remarkable results. The Carolina Abecedarian project followed 111 indigent North Carolina kids for 21 years, starting in the 1970s. Half were enrolled in an individually tailored education program from infancy to age 5, while a control group received only nutritional supplements. The program ended when the children entered

SOCIETY

# 25

Given the strong evidence of its benefits to society, preschool education for the poor—and perhaps all children—is a must

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kindergarten, after which those in both groups attended comparable public schools. The result: The pre-K attendees were less likely to drop out of school, repeat grades, or bear children out of wedlock. By 15, fewer than one-third had failed a grade, vs. more than half of the control group. At age 21, the preschoolers were more than twice as likely to have attended a four-year college.

Even scaled-back pre-K can help. Graduates of Chicago's Child-Parent Centers, which provide educational and family-support services to poor inner-city children, finish high school more often and get arrested less often than their counterparts who don't attend. Toddlers get a similar leg up from Head Start, the federal preschool program that currently serves 900,000 poor 3- and 4-year-olds across the country. Only 30% of 4-year-olds whose mothers are on welfare can count to 20 out loud or write their name correctly, according to a study of kids in California, Connecticut, and Florida. In contrast, 53% of Head Start children, a comparable demographic group, could count to 20, and 66% could write their first names.

Because the home environment is so critical to development, some programs work with parents as well. Susan Wagner Day School in Riverdale, N.Y., which serves about 200 kids from diverse economic backgrounds, requires parents to spend time at the center, particularly when their children first enroll. "In part, we do it so they learn teaching strategies they can incorporate at home," says Executive Director Joyce James.

A program in Vineland, N.J., called Impact, focuses on pregnant teenagers, giving classes

on fetal development and newborn care to two dozen young women. After they give birth, Impact teaches the kids while the mothers attend school. Each afternoon, the moms take parenting classes before they return home. Most of the teens get their high school degree; some even go on to college, which would have been highly unlikely without intervention.

A typical part-time preschool runs about \$5,000 per child per year, and about \$10,000 for a full day. Providing a mix of services for the poorest 3- and 4-year-olds—about 1.3 million kids—would cost around \$10 billion a year, according to W. Steven Barnett, director of the National Institute for Early Education Research at Rutgers University. Expanding the program to 3 million low-income children would lift the

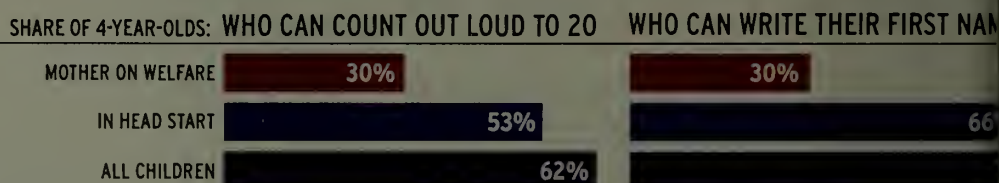
Studies show that top-notch programs yield a payback of nearly \$4 for every \$1 invested in poor children's pre-kindergarten years

to \$25 billion. But even with the least effective route, "you would get an array of long-term benefits that are an order of magnitude greater than the costs," concludes Barnett.

Right now, too many kids don't get to develop their fertile little minds just when they are most primed to learn. Of course, helping them do so won't automatically deliver that promised equality of opportunity, given the sorry state of many schools. But it would help get them started. Until every child shows up on that first day of kindergarten properly prepared to learn, America will continue to fall short of one of its bedrock ideals.

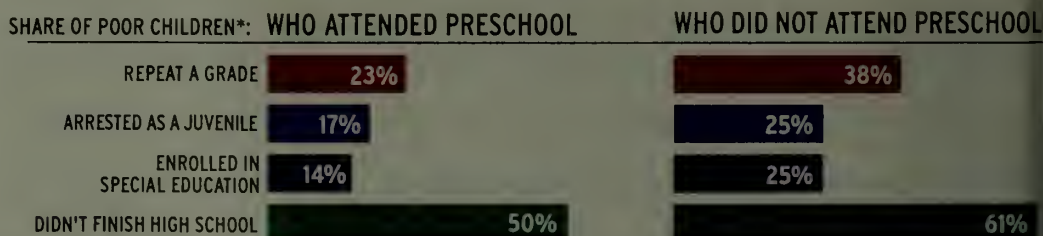
## Poor Children Lag Even Before They Start School...

Data: University of California at Berkeley, Columbia University, Stanford University



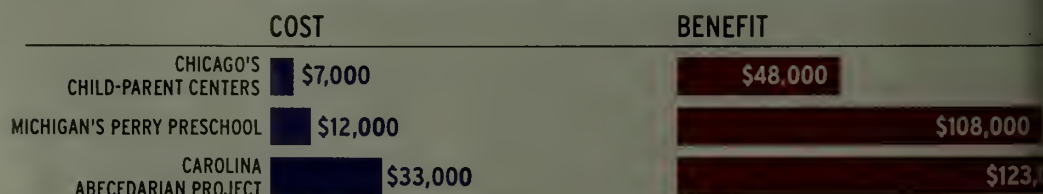
## ...But Preschool Helps Level the Playing Field...

Data: University of Wisconsin \*IN INNER-CITY CHICAGO



## ...And More Than Pays Back Society

Costs and benefits to society of three preschool programs for poor children\*\*



Data: W. Steven Barnett, Rutgers University \*\*PRESENT VALUE OF COSTS AND BENEFITS, SUCH AS LOWER CRIME AND HIGHER EMPLOYMENT AND TAX PAYMENT

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Hiring diverse, even eccentric people, mixing them up in unexpected ways, and asking them to do something unusual can prompt surprising ideas

T

By Robert Barker

To suggest that each of the ideas explored in this Bonus Issue sprang forth perfectly formed, sharp and irresistible, would be a handsome lie. The truth is that some of the early thinking was just bad. (My own sent the Scoff-o-Meters of my colleagues fluttering violently.) And with the ensuing months came the pulling of much hair, many teeth, and more than a few chains to extract 25 ideas worthy of your attention.

Which got me wondering: Might it have been easier? And where do good ideas come from, anyway? How can we nurture better ideas? These are not new questions. Yet they resist quick or certain answers. When I asked a neurologist what is it that we really know about the origin of ideas, he snapped: "You're treading in some of the deepest waters in all of science."

Forewarned, I phoned V.S. Ramachandran, director of the Center for Brain & Cognition at the University of California at San Diego. To better understand the mystery of creativity, one area he and others are studying is synesthesia. That's the phenomenon of experiencing a stimulus such as an odor not just by smelling it but also, perhaps, by "seeing" it as a color. Ramachandran explained that creative types—artists, poets, musicians, and the like—are six to seven times more likely to experience synesthesia. "And what is

creativity? Linking two seemingly unrelated things," he said. Exposure to poetry, music, art, and humor all seem to widen pathways among the brain's lobes. What might stir traffic on these paths? Intense encounters, professional or personal, with inspirational people, Ramachandran suggested. Ideas also seem to flow, he said, "when you're in love."

That sounded good to me, and it got physicist Partha Mitra chuckling. Mitra is one of Bell Laboratories' most prolific young researchers, with seven patents and four others pending. Ideas, you might say, are his business. When he hits a dry spell, he has a trick. "I go see a movie," he told me. "It sort of jogs my emotions, shakes up my brain." Mitra's best ideas seem to have popped up when he was engaged with colleagues from other disciplines, but in relaxed settings. One idea—for high-capacity antennas used in wireless communications—led to a pair of patents. It came as he had lunch with another Bell Labs scientist, Michael Andrews. "It was sort of like a jam session," he recalled. "We were having fun." And part of the fun, Mitra said, is being rebellious: No matter how much book learning you have, your ideas will be dull unless you relish the prospect of toppling at least part of some existing order.

# TM of Brain



We all know that rebels aren't usually welcome in the business world—but that's a mistake, according to Lawrence A. Bossidy, who recently retired as CEO and chairman of Honeywell International Inc.: "You've got to promote people who want to be creative and innovative. Drones don't have good ideas." Bossidy touches on turning ideas into reality in a new book, *Execution: The Discipline of Getting Things Done*. "Companies that set out in some formal, structured way to get ideas—I think that's bunk. You've got to make sure that it's done in a free-form way."

CODA

# Art forming



ent, where people have self-confidence," he said. "It comes at unsuspecting times, at unusual places." Not long after speaking with Bossidy, I saw a TV commercial for something called the Fram SureDRAIN Fast Oil Change System. Anyone who has ever changed oil knows that this little \$12.99 valve-and-hose is simply a great idea. The valve replaces a car's oil plug—which can be a pain to unscrew—while the hose can be attached to the valve to direct the old, dirty oil into a container without the danger of spilling it all over

yourself and your garage floor. Who had that brainstorm?

Fram, I found out, is owned by Honeywell, and Jim Brown, director of new-product development for Honeywell's Consumer Products Group, gets the credit. "I was on an airport shuttle in Phoenix, going to our sales meeting, and I was talking to our international sales manager," Brown said. "He had just burned his hand while changing his oil, and it got all over his driveway." Flash—Brown had the idea. He saw a way to sell to consumers the valve-and-hose oil drain systems that had been available until then only to owners of heavy-duty trucks. "We took that stuff and downsized it," he said. Why, I asked, had inspiration struck in an airport shuttle? "Because it was the beginning of the sales meeting and I was keyed up and enthusiastic," he said. "I was receptive to hearing from these guys."

The investment research firm Morningstar Inc. has been a fount of ideas since 1984, when Joseph Mansueto started the company in his two-bedroom Chicago apartment. It now employs 800 people in 17 countries. What works? Hiring diverse, even eccentric, people, Mansueto told me. Mixing people in unexpected ways, and asking them to do something unexpected, also seems to yield new ideas. For instance, Morningstar's chief financial officer, Martha Dustin Boudos, has also been its personnel chief and before that a product manager. But Mansueto thinks fearless debate may be the most important ingredient of all. "Challenging me is something that people do all the time," he said. "In front of 50 or 60 people, our COO, Tao Huang, will openly disagree with me after I've lectured on some point. He doesn't get reprimanded, and it sends a signal that the best ideas win."

Many people mentioned the mystery of togetherness, of minds meeting minds—but without the social anxiety that plagues many business encounters. Replacing that with a very basic trust is what lies beneath the best ideas, according to Mary Wells Lawrence, a founder of the ad agency Wells Rich Greene, which developed Alka-Seltzer's "Plop Plop Fizz Fizz" and the "I Love New York" campaigns.

How did her agency come up with such winners? "It's like a movie director who works with actors," she said. "Most creative people are shy, oddly. They have to give up being shy and dare to risk their ideas. They have to trust that you won't laugh at them. It takes a lot of work. They have to really believe that you respect them, that you will love them for their ideas—that you will love them. They have to have the guts to do that, and they only have the guts if they trust you."

That's only the first step, however. "Once they trust you, you get in a position where you can be very demanding of them," she added. "They'll believe you are trying to make them better, that you're trying to protect their reputation. It's a psychological kind of business: They have to come to believe that you're fanatic about them."

Lawrence describes many such situations in her recent book, *A Big Life in Advertising*. The reality, though, is most of us lead smaller lives. How many are so secure that we can engage our colleagues in ways that make unimaginable performances inevitabilities? Very few.

Just the same, we can aspire. Do you want good ideas? Do you want to spark more good ideas in others? Look back over what all these people—Ramachandran and Mitra, Bossidy and Brown, Mansueto and Lawrence—told me: Relax. Play music. Break bread with a colleague. Read a poem. Open yourself to eccentricity. Listen to someone else's story. Laugh. Resist the tyranny of drones. Seek catharsis. Get vulnerable. Do something risky. Be a rebel, with self-confidence. And, yes, with love. ■



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# The ROI of Storage

As data storage needs soar, users have a multitude of options.

**H**ave one disk drive talk to another? It's easy enough when copying a 300-Kb memo from the floppy drive to the hard drive on a PC. But it's a whole different story when, like Walter Hinton of ManagedStorage International Inc., five petabytes (or five million billion bytes) of networked data is being managed.

Consider the case of one large banking client of MSI that wanted to replicate data between two sites. The first site was using disk arrays from EMC Corp.; the other was using arrays from Hitachi Data Systems. Complicating matters, each site was using different storage protocols. "Replication between different vendors' systems doesn't work," says Hinton, chief technology officer of the Broomfield, Colo., managed storage service provider. The customer had to "buy more hardware either from EMC or from Hitachi for this replication to take place," he says.

Then the bank's Emulex Corp. host bus adapters (HBAs), which link servers to networks of storage devices, refused to work with the new Linux Web servers being installed. Emulex hadn't yet released a software driver that would allow its HBAs to work in Linux servers, Hinton says. After that, the bank had to buy new HBAs when it "already had an inventory of HBAs that weren't compatible," he adds.

While storage is becoming more critical because it holds the information required for data mining as well as for customer relationship and Web commerce systems, customers and vendors are stymied by the inability of storage hardware (such as disk and tape drives) and storage management software from different vendors to communicate with each other.

This lack of a common storage language raises the cost of managing storage, forces customers to buy more storage hardware than they need and makes it harder for security-conscious companies to easily transfer data among backup facilities. Fed-up customers are sitting on their wallets rather than be locked into a single vendor's hardware, or software simply because the product can't work with products from other vendors.

## Customers Have Long Memories

Aventis Behring, a rapidly growing life sciences company based in King of Prussia, Pa., found itself struggling with a storage challenge similar to Hinton's. The company, which specializes in blood plasma and bleeding disorders, runs critical applications, each of which is connected to its own vital storage. Sustained rapid growth, however, forced Aventis Behring to either continually buy more storage than it needed for each application or risk running short and constraining applications that control vital clinical trials or support production and research operations.

Quickly, managers realized the situation for what it was: a prescription for disaster. At some point, the company was bound to run out of storage for a mission-critical application or money or both.

Complicating the situation was the lack of effective, high-level storage

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management tools that could manage the storage for all the applications together. "It is very expensive to manage the storage for each application separately," says Behrad Talebzadeh, director/IS infrastructure at Aventis Behring.

Storage vendors hear the demands and have made progress in many areas, such as the ability for storage devices from different vendors to communicate with each other. They also are working on common languages to make it easier for customers to mix and match hardware and software from different vendors.

Once all the incompatibilities are resolved, it's more important today than ever to protect that data. "Recent history has underlined the value of disaster recovery plans," says Andy Lawrence, marketing manager for Kodak's Integrated Imaging Unit.

## Management Muddle

Storage interoperability was not so important in the days when most disk drives were attached to mainframe computers in a corporate data center located inside a departmental server. In such cases, the disk drives and the computers to which they were attached often came from a small well-known group of vendors, were accessed by the same applications and were managed by the same staff.

But this simple storage model collapsed under the weight of increasing amounts of data generated by e-commerce and the growing need to share information among various parts of the same company as well as with customers and suppliers. As companies began storing more data on more types of storage devices, the cost of managing that storage — and users' access to it — often grew many times higher than the cost of the storage itself.

The cost of managing storage is much higher than the cost of storage itself.

Hence, the idea of linking storage devices on their own dedicated networks so the data contained within each device could be more easily accessed by a variety of applications and users. But with networking came its own complexities, as different vendors introduced different backup protocols, different formats for writing data to tape drives, different network standards and different types of software agents for performing backup.

Customers buying, say, a disk array from a major storage vendor must sort through graphs that explain which operating systems, which HBAs, which storage network switches and which version of the switch's firmware (embedded control software) will work with that specific array, says Dianne McAdam, an analyst at Illuminata Inc. in Nashua, N.H.

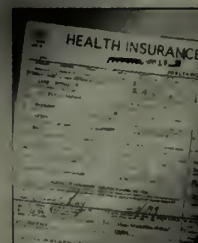
An even bigger challenge, according to analysts, vendors and customers alike, is to make it easier for different storage management applications to work together. Today, customers are forced to buy one management application that "does maybe three of the five things they really need to do and get another package which does two of the five," McAdam says. "We need these packages to be able to talk to each other, so customers aren't stuck with separate management consoles for each software package." ■

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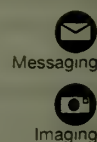
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it is steady

**T**riarc (TRY), the investment vehicle of savvy dealmakers Nelson Peltz (chairman and CEO) and Peter May (president and chief operating officer), is a deal waiting to happen. Triarc is on the prowl for yet another buy that could yield rich returns. Or the company itself could be a target, mainly because of its major asset—Arby's, the 10th-largest fast-food chain, with 3,323 outlets in the U.S. and Canada. Although Peltz says neither Triarc nor Arby's is for sale "at this time," he declines to say whether he has had any offers. Peltz and May own 34% of Triarc.

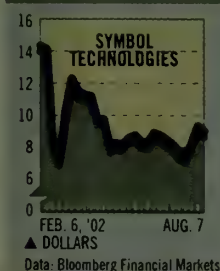
They need a deal soon to boost Triarc's price. Shares fell from 28.55 on May 15 to 23 on July 22, in part because Triarc lost its bid to buy Burger King, which analysts say could have been a high-return acquisition and push company earnings way up. Texas Pacific Group won the bidding. Triarc is now at 24.

Triarc has a cash hoard of \$700 million, or \$30 a share, notes Michael Gallo, an analyst at investment firm CL King & Associates, who rates the stock a strong buy. (He doesn't own shares, and CL King has no banking ties with Triarc.) Arby's is worth a further \$12 a share, figures Gallo. Triarc is an enticing sum-of-the-parts play, he argues. Whether or not Triarc bags another prize company or ends up as the big catch, Gallo says "Triarc at its current price is a compelling value."

Analyst Jan Loeb of investment firm Jefferies, who also rates Triarc a buy, says Peltz and May have an enviable 20-year record of buying and selling businesses. (Neither Loeb nor Jefferies owns shares.) One such deal: The acquisition of Snapple Beverage Group in 1997 for \$300 million. In 2000, Triarc sold it for \$1.4 billion to Cadbury Schweppes. Loeb sees Triarc doing another deal this year that may be the "last hurrah" for Peltz and May, who both turned 60 this year.

## AT SYMBOL, MORE THAN MEETS THE EYE

### THE WORST COULD BE OVER



**S**ymbol Technologies (SBL), which makes portable bar-code scanners, is by no means on Easy Street. Overall info-tech spending is on the skids, and the Securities & Exchange Commission is looking into some of Symbol's revenue-recognition practices. So why has the company reappeared on certain pros' radar screens? "The worst is likely behind it," says Scot Ciccarelli of investment firm Gerard Klauer Mattison, who has upgraded his rating from

"outperform" to "buy," with a 12-month target of 14. The stock is now at 9.

"It's not easy to upgrade this stock, given the slump in IT spending and the bearish tones of the market," says Ciccarelli (who doesn't own shares). "But Symbol's technology and strategy remain sound," he says, and insiders have been buying—even after the SEC probe started. "That tells me," he says, "that management isn't too concerned about its accounting." Symbol posted "very solid" second-quarter results, he notes. The company may already have hit its low, with fundamentals on the mend and with the hiring of ex-Cisco Systems executive Bill Nuti as president and COO—a good thing, says Gallo, who sees Symbol earning 22¢ a share in 2002 and 50¢ in 2003, vs. 2001's 26¢. (He doesn't own shares.)

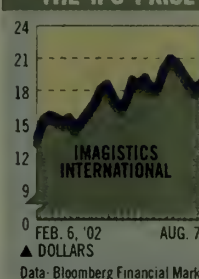
Nissim Aboodi, president of money-manager Questrion, who owns Symbol shares, doubts the SEC probe will impair Symbol's balance sheet, affecting only certain quarters in 2000 and 2001. In the meantime, he notes that Symbol's markets are expanding to the health-care field.

## PLENTY OF TONER AT IMAGISTICS

**S**pun off by Pitney Bowes on Dec. 3, 2001—during one of the worst bear markets ever—Imagistics International (IGI) achieved the nearly impossible: The stock has managed to stay way above its initial price of 12 a share: It's currently at 18.95. Chairman Marc Breslawsky attributes the stock's strong showing to the support of some big institutional investors who know Imagistics' products and services quite well.

The company, formerly a Pitney Bowes unit that marketed its copying and fax machines, is the largest independent provider of such machines, including those made by giants Panasonic and Minolta. Imagistics' customers in the \$17 billion market include some 60% of the world's blue-chip companies, including IBM, Citigroup, and the U.S. Postal Service. "One of the key strengths of Imagistics is the fact that it doesn't make anything—it relies on major manufacturers in Asia," says Herbert Hardt, a partner at investment firm Monness, Crespi, Hardt, who rates the stock a buy. (He doesn't own shares.) One distinct feature of Imagistics products, he says, is that they are customized to the needs of major customers. Hardt figures Imagistics will earn 80¢ a share this year and \$1.25 in 2003.

### WAY ABOVE THE IPO PRICE

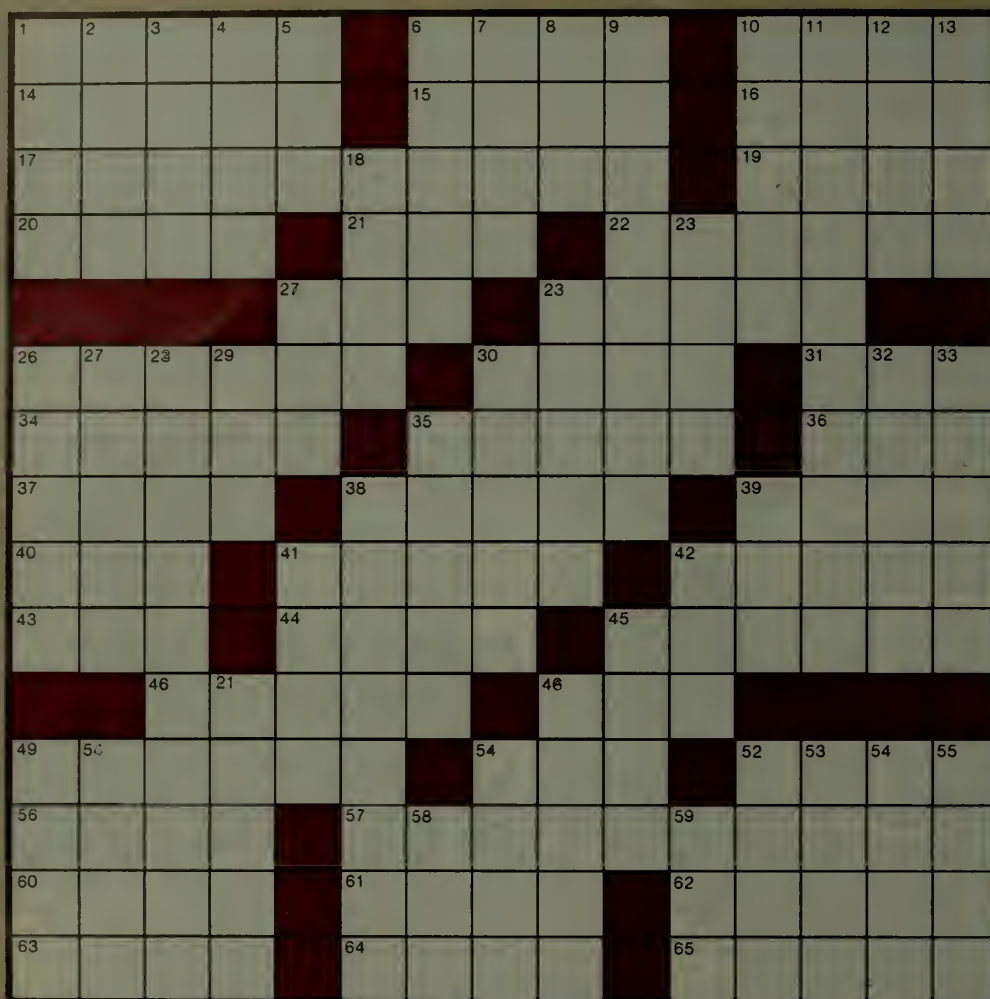


BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at [www.businessweek.com/today.htm](http://www.businessweek.com/today.htm). And see him Fridays at 1:10 p.m. EST on CNNfn's *The Money Gang*.



# Mixing Business with Pleasure by Lincoln



## ACROSS

1. Movado competitor
6. Military school: Abbr.
10. Sail support
14. Large union, for short
15. Columbia Pictures owner
16. "... \_\_ saw Elba"
17. R&D goal
19. Federal agents
20. Roulette bet
21. One side of an issue
22. Pipeline place
24. Big name in ATMs
25. Insignificant

26. Start up the computer again
30. Zachary Taylor, for one
31. Fairness in hiring: Abbr.
34. Decorate
35. Talks up
36. Hush-hush organization: Abbr.
37. "As \_\_ saying..."
38. Strong suit
39. Impediments to teamwork
40. Richard Branson's title
41. Plummets
42. EVP, e.g.
43. Conclude
44. Bills not yet made over

45. Grain unit
46. Air traffic controller's device
48. Notice
49. Ad agency's creation
51. Imitate
52. Hammer part
56. Low-quality
57. Identity theft, perhaps
60. Mythical company in Warner Bros. cartoons
61. Novelist Ambler
62. Branch of law or engineering
63. Increase
64. Aerospatiale products
65. Bethlehem's business

## DOWN

1. "Because there's \_\_, kids and groceries..." (see page at right)
2. \_\_ importance (insignificant)
3. Actress Anderson
4. Get an \_\_ effort
5. Half of XC
6. Early American monopoly
7. Make cents
8. "I'll take that as \_\_"
9. Nobel's invention
10. Copper or chromium
11. Type of transaction
12. Look for
13. Singer Turner
18. S&L customer: Abbr.
23. Falls behind
24. "Smoking" alternative
25. Suspends business
26. Merit reward
27. Inventor Land
28. Corporate power center
29. Hospital areas: Abbr.
30. Watch's innards
32. "\_\_ Mio"
33. Flipchart holder
35. Copier supply
38. Monetary resources
39. "\_\_ for Evidence" (Grafton book)
41. Scotch partner
42. Calendar column
45. Busch's business
47. Be of one mind
48. Architectural details
49. Train for a bout
50. Centers of activity
51. Slightly
52. Faultfinding, for short
53. Not prerecorded
54. French girlfriend
55. "... And those who travel..." (See page at right)
58. Accounting periods: Abbr.
59. Medicinal amounts: Abbr.

For answers to this puzzle:

Turn to page **177** in this week's issue of BusinessWeek or visit [Mixing Business with Pleasure by Lincoln on www.businessweek.com/adsections](http://Mixing Business with Pleasure by Lincoln on www.businessweek.com/adsections)

Puzzle created by: Stanley Newman.



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## Stocks



### COMMENTARY

Data suggesting that the U.S. economy may be grinding to a halt sent markets spiraling downward for three days before stocks staged a rally on Aug. 6-7. The cause for optimism was the growing belief that the Federal Reserve will move to lower rates once again to maintain growth. For the week, the Dow, Nasdaq, and S&P 500 fell 3.2%, 3.6%, and 3.8%, respectively.

Data: Bloomberg Financial Markets  
Reuters

## U.S. MARKETS

|                       | Aug. 7 | Week | Year to date | Last 12 months |
|-----------------------|--------|------|--------------|----------------|
| S&P 500               | 876.8  | -3.8 | -23.6        | -27.2          |
| Dow Jones Industrials | 8456.2 | -3.2 | -15.6        | -19.1          |
| Nasdaq Composite      | 1280.9 | -3.6 | -34.3        | -36.8          |
| S&P MidCap 400        | 425.2  | -3.7 | -16.3        | -15.7          |
| S&P SmallCap 600      | 193.7  | -2.4 | -16.6        | -14.1          |
| Wilshire 5000         | 8298.0 | -3.7 | -22.5        | -25.5          |

## SECTORS

|                              | Aug. 7 | Week | Year to date | Last 12 months |
|------------------------------|--------|------|--------------|----------------|
| BusinessWeek 50*             | 540.5  | -2.7 | -26.0        | -34.6          |
| BusinessWeek Info Tech 100** | 268.5  | -3.9 | -36.0        | -38.1          |
| S&P/BARRA Growth             | 453.5  | -3.0 | -23.7        | -24.9          |
| S&P/BARRA Value              | 420.1  | -4.8 | -23.9        | -30.1          |
| S&P Energy                   | 177.7  | -6.4 | -15.9        | -20.1          |
| S&P Financials               | 296.3  | -4.3 | -16.6        | -21.5          |
| S&P REIT                     | 94.3   | -3.0 | 1.0          | 0.5            |
| S&P Transportation           | 169.7  | -3.8 | -13.9        | -16.1          |
| S&P Utilities                | 104.1  | -1.4 | -28.6        | -41.1          |
| GSTI Internet                | 60.5   | -6.4 | -42.3        | -48.0          |
| PSE Technology               | 434.4  | -4.2 | -36.8        | -37.0          |

\*Mar. 19, 1999=1000 \*\*Feb. 7, 2000=1000

## BEST-PERFORMING GROUPS

|                       | Last month % | Last 12 months % |
|-----------------------|--------------|------------------|
| Biotechnology         | 16.5         | 41.6             |
| Food Wholesalers      | 3.1          | 36.8             |
| Casinos               | 3.1          | 28.6             |
| Tobacco               | 2.7          | 22.9             |
| Photographic Products | 2.5          | 21.7             |

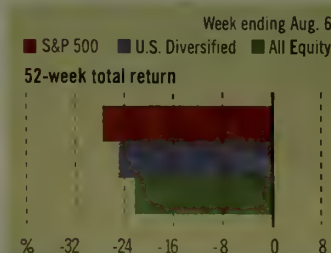
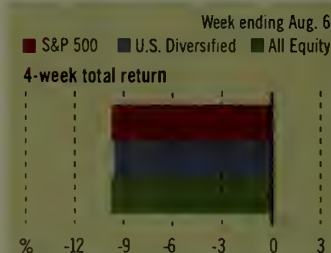
## EQUITY FUND CATEGORIES

| 4-week total return   | %     | 52-week total return       | %     |
|-----------------------|-------|----------------------------|-------|
| <b>Leaders</b>        |       | <b>Leaders</b>             |       |
| Health                | 2.1   | Precious Metals            | 42.7  |
| Domestic Hybrid       | -5.6  | Real Estate                | 4.2   |
| Real Estate           | -6.1  | Pacific/Asia ex-Japan      | -1.3  |
| International Hybrid  | -6.5  | Diversified Emerging Mkts. | -3.8  |
| <b>Laggards</b>       |       | <b>Laggards</b>            |       |
| Precious Metals       | -19.0 | Communications             | -52.1 |
| Pacific/Asia ex-Japan | -14.8 | Technology                 | -48.8 |
| Natural Resources     | -14.7 | Utilities                  | -31.7 |
| Europe                | -14.2 | Large-cap Growth           | -31.5 |

## EQUITY FUNDS

| 4-week total return           | %     | 52-week total return      | %     |
|-------------------------------|-------|---------------------------|-------|
| <b>Leaders</b>                |       | <b>Leaders</b>            |       |
| ProFunds UltraBear Inv.       | 17.0  | Rydex Dynam. Venture 100  | 110.3 |
| Rydex Dynam. Tempest 500      | 16.5  | ProFunds UltraShort OTC   | 104.6 |
| Smith Barney Biotech. I       | 14.9  | First Eagle SoGen Gold    | 81.5  |
| Rydex BioTechnology Inv.      | 14.5  | Prudent Bear              | 80.5  |
| <b>Laggards</b>               |       | <b>Laggards</b>           |       |
| U.S. Global Investors Gold    | -25.0 | ProFunds UltraOTC Inv.    | -78.1 |
| U.S. Glob. Wrld. Prec. Minls. | -23.6 | Rydex Dynam. Velocity 100 | -77.5 |
| Matthews Asian Technology     | -23.5 | Black Oak Emerging Tech.  | -71.8 |
| AXP Precious Metals A         | -22.3 | Van Wagoner Post Venture  | -64.0 |

## Mutual Funds



Data: Standard & Poor's

## GLOBAL MARKETS

|                             | Aug. 7 | Week |
|-----------------------------|--------|------|
| S&P Euro Plus (U.S. Dollar) | 838.2  | -4.6 |
| London (FT-SE 100)          | 4094.4 | -3.6 |
| Paris (CAC 40)              | 3270.5 | -4.2 |
| Frankfurt (DAX)             | 3465.5 | -6.3 |
| Tokyo (NIKKEI 225)          | 9834.4 | -0.4 |
| Hong Kong (Hang Seng)       | 9977.7 | -2.8 |
| Toronto (TSE 300)           | 6486.7 | -0.4 |
| Mexico City (IPC)           | 5855.9 | -2.8 |

## FUNDAMENTALS

|                                      | Aug. 6 | Wk   |
|--------------------------------------|--------|------|
| S&P 500 Dividend Yield               | 1.80%  | 1.7  |
| S&P 500 P/E Ratio (Trailing 12 mos.) | 31.1   | 32   |
| S&P 500 P/E Ratio (Next 12 mos.)*    | 15.2   | 16   |
| First Call Earnings Revision*        | -3.54% | -3.1 |

## TECHNICAL INDICATORS

|                                       | Aug. 6 | Wk     |
|---------------------------------------|--------|--------|
| S&P 500 200-day average               | 1080.5 | 1085.9 |
| Stocks above 200-day average          | 28.0%  | 33.8   |
| Options: Put/call ratio               | 0.82   | 0.61   |
| Insiders: Vickers NYSE Sell/buy ratio | 3.01   | 3.11   |

## WORST-PERFORMING GROUPS

|                       | Last month % |
|-----------------------|--------------|
| Semiconductors Equip. | -29.2        |
| Multi-Utilities       | -28.5        |
| Employment Services   | -28.5        |
| Oil & Gas Drilling    | -27.7        |
| Paper Packaging       | -26.1        |

## Interest Rates

### KEY RATES

|                                | Aug. 7 | Week ago |
|--------------------------------|--------|----------|
| <b>MONEY MARKET FUNDS</b>      | 1.41%  | 1.41%    |
| <b>90-DAY TREASURY BILLS</b>   | 1.58   | 1.69     |
| <b>2-YEAR TREASURY NOTES</b>   | 1.97   | 2.24     |
| <b>10-YEAR TREASURY NOTES</b>  | 4.30   | 4.46     |
| <b>30-YEAR TREASURY BONDS</b>  | 5.22   | 5.30     |
| <b>30-YEAR FIXED MORTGAGE†</b> | 6.35   | 6.44     |

†BancQuote, Inc.

## BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 30% federal tax rate.

|                              | 10-yr. bond |
|------------------------------|-------------|
| <b>GENERAL OBLIGATIONS</b>   | 3.86%       |
| <b>TAXABLE EQUIVALENT</b>    | 5.51        |
| <b>INSURED REVENUE BONDS</b> | 4.07        |
| <b>TAXABLE EQUIVALENT</b>    | 5.81        |

## THE WEEK AHEAD

**RETAIL SALES** Tuesday, Aug. 13, 8:30 a.m. EDT ► Retail sales in July probably rose 1.0%. Excluding vehicles, sales probably grew by 0.4% in July. That's based on the median forecast of economists surveyed by Standard & Poor's MMS, a unit of The McGraw-Hill Companies.

**FOMC MEETING** Tuesday, Aug. 13, 9 a.m. EDT ► The Federal Reserve Board's Open Market Committee meets to set monetary policy. Economists surveyed by S&P's MMS expect the Fed to leave the federal funds

rate at 1.75% and maintain a neutral bias between signs of economic weakness and inflation.

**BUSINESS INVENTORIES** Wednesday, Aug. 14, 8:30 a.m. EDT ► Inventories are forecast to have grown by 0.1% in June.

**INDUSTRIAL PRODUCTION** Thursday, Aug. 15, 9:15 a.m. EDT ► Factory output in July probably rose by a scant 0.1%, after a 0.8% surge in June. The average operating rate most likely slipped to 76%.

**NEW RESIDENTIAL CONSTRUCTION** Friday, Aug. 16, 8:30 a.m. EDT ► Housing starts likely declined 1.8%, to an annual rate of 1.64 million units, in July.

**CONSUMER PRICE INDEX** Friday, Aug. 16, 8:30 a.m. EDT ► Consumer prices for goods and services are forecast to increase 0.2% during July, following a 0.1% rise in June. Excluding the food and energy components, core inflation most likely grew by 0.2%, after a 0.1% rise in June.

## BusinessWeek Fifty

THE  
BUSINESSWEEK **50**

Feb.

Aug.

Weekly

Daily: Aug. 1-7

580

555

540.5

530

505

480

2.7% for the week—less of a decline than the major indexes, but certainly nothing to boast. The losers were Calpine, which sank 38.6%, followed closely by fellow energy outfit Dynegy, down 20.3%, and Household International, off 10.3%, gave the bright spot was medical-device maker Stryker, which rose 2.0%.

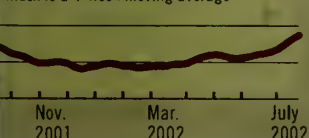
## COMPANY PERFORMANCE

| Company                       | % change |              | Rank | Company                       | % change |              |
|-------------------------------|----------|--------------|------|-------------------------------|----------|--------------|
|                               | Week     | Since 3/1/02 |      |                               | Week     | Since 3/1/02 |
| Johnson & Johnson             | -0.9     | -13.8        | 26   | Tenet Healthcare              | 0.0      | 23.8         |
| Calpine                       | -3.7     | -6.4         | 27   | Household International       | -10.3    | -25.7        |
| Dynegy                        | -2.1     | -22.7        | 28   | WellPoint Health Networks     | -3.0     | 14.0         |
| Household International       | -7.2     | -22.2        | 29   | Washington Mutual             | -1.9     | 12.8         |
| Duke Energy                   | 0.0      | -12.6        | 30   | Duke Energy                   | 1.0      | -27.1        |
| Kohl's                        | -6.3     | -36.3        | 31   | Kohl's                        | 0.4      | -2.1         |
| Bed Bath & Beyond             | -4.3     | -8.4         | 32   | Bed Bath & Beyond             | -6.4     | -13.1        |
| Cardinal Health               | -3.6     | -19.4        | 33   | Cardinal Health               | 0.5      | -12.4        |
| Centex                        | -6.4     | -31.4        | 34   | Centex                        | -6.0     | -22.8        |
| American Electric Power       | -2.8     | -3.8         | 35   | American Electric Power       | -4.0     | -28.0        |
| Golden West Financial         | -2.5     | 17.9         | 36   | Golden West Financial         | -1.7     | 1.4          |
| Stryker                       | -1.8     | -2.2         | 37   | Stryker                       | 2.0      | -16.0        |
| Harley-Davidson               | -8.5     | -43.5        | 38   | Harley-Davidson               | -3.7     | -11.1        |
| PepsiCo                       | -1.6     | -22.0        | 39   | PepsiCo                       | 0.0      | -15.0        |
| Merck                         | -20.8    | -92.6        | 40   | Merck                         | -1.3     | -20.2        |
| Apache                        | 0.1      | -10.8        | 41   | Apache                        | -4.5     | -6.7         |
| Amerada Hess                  | -5.6     | -17.3        | 42   | Amerada Hess                  | -4.7     | -5.9         |
| KB Home                       | -8.9     | -11.3        | 43   | KB Home                       | -3.7     | 1.9          |
| First Data                    | -2.7     | -6.9         | 44   | First Data                    | -2.7     | -16.6        |
| Tyco International            | -38.6    | -58.5        | 45   | Tyco International            | -4.6     | -58.0        |
| International Game Technology | 0.0      | 0.9          | 46   | International Game Technology | -0.5     | -14.2        |
| Capital One Financial         | 0.0      | -11.9        | 47   | Capital One Financial         | -20.3    | -48.7        |
| Electronic Data Systems       | 0.0      | -7.7         | 48   | Electronic Data Systems       | -6.0     | -41.5        |
| Nabors Industries             | -4.3     | -15.6        | 49   | Nabors Industries             | -11.0    | -23.5        |
| Xcel Energy                   | -6.0     | -30.3        | 50   | Xcel Energy                   | 12.1     | -67.0        |

## Production Index

Change from last week: 0.7%  
Change from last year: -1.2%

INDUSTRIAL OUTPUT July 27=167.4 1992=100  
The index is a 4-week moving average



The index continued to rise. Before calculating our four-week moving average, though, the index was 168.4, from 168.5. After seasonal adjustment, production and rail-freight traffic posted the largest increases. Autos, crude-oil refining and all had small gains for the week. Truck production and electric-power production were the only declines. The production index over July 2002 was 167.4, from 162.7 for all of June.

For more information on the index components is at [www.businessweek.com](http://www.businessweek.com)  
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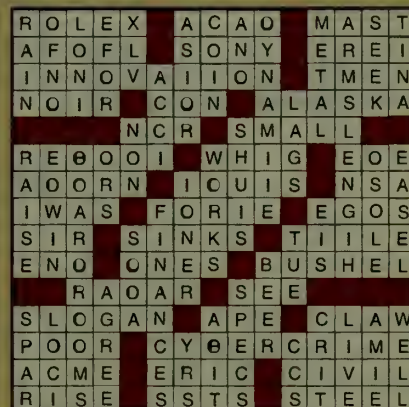
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## Mixing Business with Pleasure by Lincoln



Answers from this week's  
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# TALKING OURSELVES INTO RECESSION

**E**nough! Americans are working themselves into a state of high anxiety this summer. August angst is replacing holiday fun as people fret about the future. It's as if we have shifted from irrational exuberance to irreversible depression. If this negative psychology keeps up, we could conceivably talk ourselves into a double-dip recession as everyone becomes risk-averse. Already individual investors are pulling billions out of stock mutual funds and CEOs are in a defensive crouch, refusing to invest capital for growth. People are so fearful and weighed down by the recent past that they are blinded to the remarkable progress being made in reforming the economy and securing the nation. It's time for Americans to get a grip and get back in the game.

Of course, this has been a year like few others, transforming our lives in ways that are not yet clear. Assumptions about personal safety, economic security, and ethical leadership have been undermined. There are lingering fears about terrorism and deep insecurities about retirement. Talk about invading Iraq and new revelations about corporate corruption are keeping people on edge. Finally, the looming anniversary of September 11 and the prospect of seeing terrible images once again is unnerving.

But nerve is just what America needs most now. The extraordinary resiliency and flexibility of the U.S. to respond to crisis, even multiple crises, is evident everywhere. The markets have revalued corporate earnings and behavior in a brutal and efficient manner. Big changes in corporate governance are already in the works as the stock exchanges demand new, independent boards of directors. Credibility is be-

ing restored to financial statements as CEOs rush to meet Aug. 14 deadline set by the Securities & Exchange Commission to swear under oath that their books are clean. Standard & Poor's is beginning to estimate core earnings that do away with the flim-flam of the '90s for all companies. The Justice Dept., the SEC, and state attorneys general are busting crooked CEOs and companies and forcing reform on Wall Street analysts. Even Washington, usually slow to act on most issues, rushed through the Sarbanes/Oxley Act in 2002 to boost regulation of the accounting profession that failed America in recent years and to tighten criminal statutes against law-breaking executives.

The truth is that the U.S. has just experienced a new era of economic reform unlike anything seen since the 1930s. It has happened at lightning speed—too fast, perhaps, for investors and business managers to recognize how much progress has been made in restoring integrity and fairness to the system. Stuck in a paralyzing malaise, people are not seeing the progress in raising not only the quality of products but profit margins themselves. They are ignoring sustained gains in productivity growth, a small but real bounceback in capital spending, and a rebound of the dollar, which is evidence that foreign investors may be returning to U.S. stock and bond markets.

What is needed now is confidence—confidence in ourselves and in our future. The nation's psychology has yet to catch up with the reality of the changes put in place. The field is getting level again, the rules are more transparent and the game goes on. It's time to get back in.

# A GOOD REPORT CARD FOR CONGRESS

**T**he 107th Congress, split between a Democratic-controlled Senate and a Republican-controlled House, has left Washington on summer vacation, leaving behind a surprising legacy of good legislative work. Despite bipartisan bickering and an approaching November election, members of Congress by and large worked together. There is just one grade where Congress deserves an "F" and that is on the failure to pass a Homeland Security bill before its recess. The rest of the report card shows "A's" and "B's."

Congress, of course, gets an obvious "A" for its swift passage of the Sarbanes-Oxley corporate accountability law approved in late July. But it also deserves a high grade for the Trade Promotion Authority legislation signed into law by President Bush on Aug. 6. Fast track, as it is known, will make it easier for the U.S. to reach agreements that break down trade barriers around the world. It is now up to the President and his Trade Representative, Robert Zoellick, to conclude long-planned deals with Chile, Singapore, Morocco, Australia, Central America, and Southern Africa.

Congress also merits an "A" for finally passing the McCain-Feingold campaign-reform bill, designed to reduce the role of special interest groups in elections. But the grade gets lowered to a "B" because both parties are trying to water down provisions down via the hapless Federal Election Commission.

Lastly, lawmakers deserve high marks for what they did not do. They didn't pass energy legislation proposed by President Bush that was long on drilling and short on conserving. And they didn't make permanent long-term tax cuts that might be better reconfigured to boost growth sooner than later.

When Congress comes back in the fall, it has more work to do. Budget discipline is gone, and while fiscal stimulus is good for the economy in the short run, it could prove disastrous long-term. A reasonable compromise on prescription drugs is needed that doesn't bankrupt Medicare. A balanced energy bill is needed, especially as the Mideast seethes. Ideological disagreements over civil-service protection for employees of the new Homeland Security Dept. have yet to be resolved. Congress had a good year. It needs another.

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